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Crisis and consolidation in the public finances

Jon Riley & Robert Chote

September 2014

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Abstract

In the 12 years from the outbreak of the global financial crisis in 2007-08 to the end of our current medium-term forecast in 2018-19, the UK public finances will have suffered their largest peacetime shock in living memory, followed – on current policy – by one of the biggest deficit reduction programmes seen in any advanced economy since World War II. This paper explains the expected evolution of the public finances over the entire period. It looks back at how the public finances were forecast to evolve in Budget 2008, before the full extent of the financial crisis was apparent, and goes on to describe what happened instead. We then look at how the public finances are projected to return to balance and how the composition of spending and receipts will have changed.

We are grateful for the hard work and input from numerous OBR staff, including Andy King, Philippa Todd, Tom Pybus, Pavandeep Dhani, Sebastian Salaforis, Emily Hutchison, Joe Robins and Stephen Foreman. We are also very grateful to Alistair Darling, for agreeing to our use of previously unpublished forecasts from his time as Chancellor of the Exchequer.

Contents

Chapter 1	Executive summary.....	1
Chapter 2	The pre-crisis picture	9
Chapter 3	What happened instead	25
Chapter 4	Receipts.....	63
Chapter 5	Public spending	85
Chapter 6	Back to balance?	111
	Index of charts and tables.....	133

1 Executive summary

- 1.1 In the 12 years from the outbreak of the global financial crisis in 2007-08 to the end of our current medium-term forecast period in 2018-19, the UK public finances will have suffered their largest peacetime shock in living memory, followed – on current policy – by one of the biggest deficit reduction programmes seen in any advanced economy since World War II.
- 1.2 The evolution of the public finances over this period will reflect the way in which developments in the economy and financial markets interact with the tax and spending policies that were in place prior to the crisis, and then those implemented subsequently – initially to ameliorate the impact of the recession and now to address its fiscal legacy.
- 1.3 Understanding how this interaction has played out – and will continue to play out – is important to the OBR in helping us assess and predict developments in the public finances in the future. It should also be important to policymakers and would-be policymakers in trying to design tax and spending policies appropriate for good and not-so-good times.
- 1.4 Looking back to the pre-crisis era, it is hard to argue that the tax and spending policies implemented in the early and mid-2000s were in themselves an important cause of the crisis and recession. But there were undoubtedly weaknesses in fiscal management during that period, some apparent at the time and some more with the benefit of hindsight.
- 1.5 The then Labour Government increased public spending significantly as a share of GDP in the mid-2000s, arguing that this would be paid for by an increase in tax receipts that then did not fully materialise. External forecasters were consistently – and rightly – more pessimistic about the fiscal outlook than the Government. Public sector net debt increased during a period when it was being reduced significantly in most other industrial countries. And the OECD said at the time (and says more forcefully now) that the UK entered the financial crisis with one of the largest structural budget deficits in the industrial world. This limited the Government's perceived room for manoeuvre when the crisis hit.
- 1.6 And, when the crisis did hit, the fiscal consequences were dramatic. The budget deficit quadrupled between 2007-08 and 2009-10, reaching £157 billion or 11 per cent of GDP – and it was still £115 billion or 7 per cent of GDP three years later. Public sector net debt increased by £647 billion, doubling to 74 per cent of GDP, over the same five years.

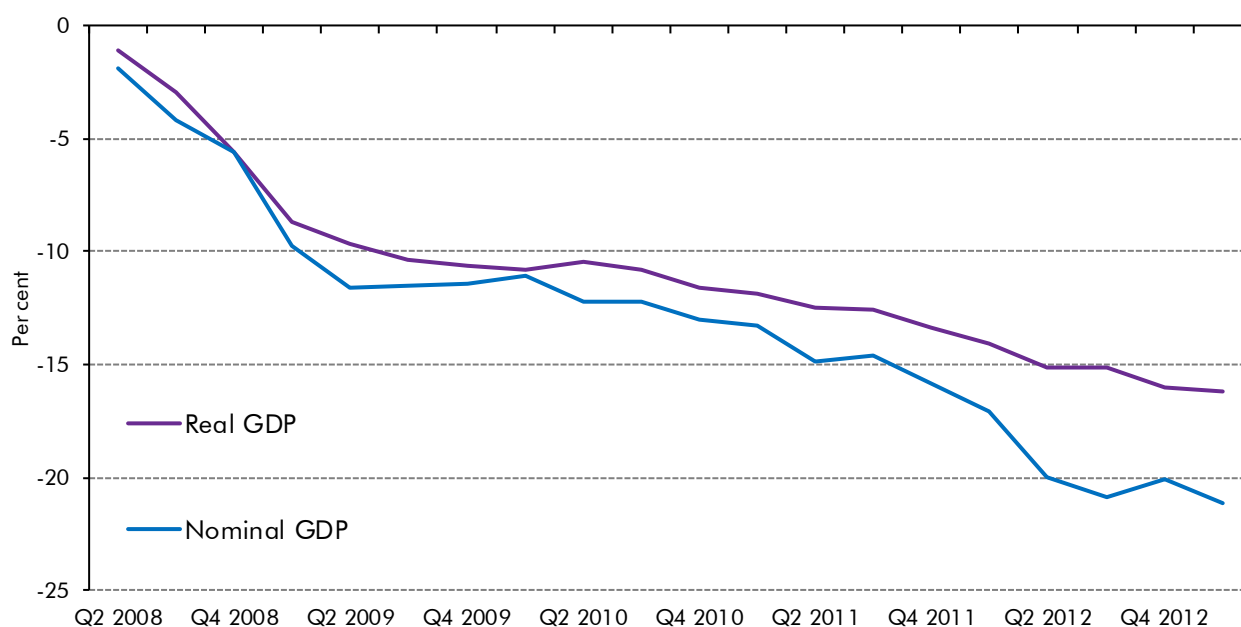
Table 1.1: Net borrowing and net debt: March 2008 forecast and outturns

	£ billion					
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Public sector net borrowing						
Budget 2008 forecasts	36.4	42.5	38.4	32.4	27.3	22.7
Outturns	38.0	99.4	157.3	139.2	118.0	115.1
<i>Differences from Budget 2008</i>	1.5	56.8	118.9	106.8	90.7	92.4
Public sector net debt						
Budget 2008 forecasts	534	581	627	666	700	731
Outturns	538	633	829	1,005	1,106	1,185
<i>Differences from Budget 2008</i>	3	52	202	339	406	454
	Per cent of GDP					
Public sector net borrowing						
Budget 2008 forecasts	2.6	2.9	2.5	2.0	1.6	1.3
Outturns	2.6	6.9	11.0	9.3	7.6	7.3
<i>Differences from Budget 2008</i>	0.0	4.0	8.5	7.3	6.0	6.1
Public sector net debt						
Budget 2008 forecasts	37.1	38.5	39.4	39.8	39.7	39.3
Outturns	36.8	44.6	56.4	65.9	71.2	74.2
<i>Differences from Budget 2008</i>	-0.3	6.1	17.0	26.1	31.5	34.9

- 1.7 Only a small proportion of the unexpected increase in borrowing in 2009-10 – around 1.3 per cent of GDP – was the direct result of discretionary fiscal stimulus measures. This was reversed in 2010-11, with tax increases and spending cuts building up and directly reducing the deficit by about 4 per cent of GDP by 2012-13 (excluding any feedback effects).
- 1.8 Looking beyond the direct impact of the discretionary policy measures, there was a substantial deterioration in the underlying budget deficit during the recession that has persisted through the early years of the recovery. The scale of that deterioration reflects the way in which various developments in the economy – some unusual even for a recession – interacted with tax and spending policies that were designed for more normal times.
- 1.9 The key economic developments that have shaped the public finances are:
- **the weakness of nominal GDP:** the cash size of the economy (nominal GDP) fell far below pre-crisis expectations and also shrank in absolute terms between 2007-08 and 2009-10. Nominal GDP normally continues rising in recessions, even when real GDP – the volume of goods and services produced in the economy - falls;
 - **stubbornly high consumer price inflation:** consumer prices, which had been relatively contained prior to the crisis, rose significantly more than expected through to 2012-13, even though activity in the real economy was far weaker than expected;
 - **the productivity puzzle:** employment was weaker than forecast prior to the crisis, but it has held up far better than anyone would have expected given the size of the fall in real GDP. So productivity – output per hour worked – was and remains very weak;

- **falling real wages:** average earnings have grown very slowly by historical standards, mirroring the weakness of productivity. Combined with stubbornly high consumer price inflation, this has seen real wages fall significantly since the outbreak of the crisis;
- **a disproportionate hit to the financial sector:** salaries, bonuses and profits in the normally revenue-rich financial sector fell further than those in the rest of the economy and further than in most recent recessions, reflecting the origins of the crisis; and
- **very low interest rates and weak asset markets:** short-term policy interest rates and government borrowing costs have fallen very sharply and remain very low. Equity prices and property prices and transactions also fell well short of pre-crisis forecasts.

Chart 1.1: Cumulative errors in March 2008 forecast for real and nominal GDP

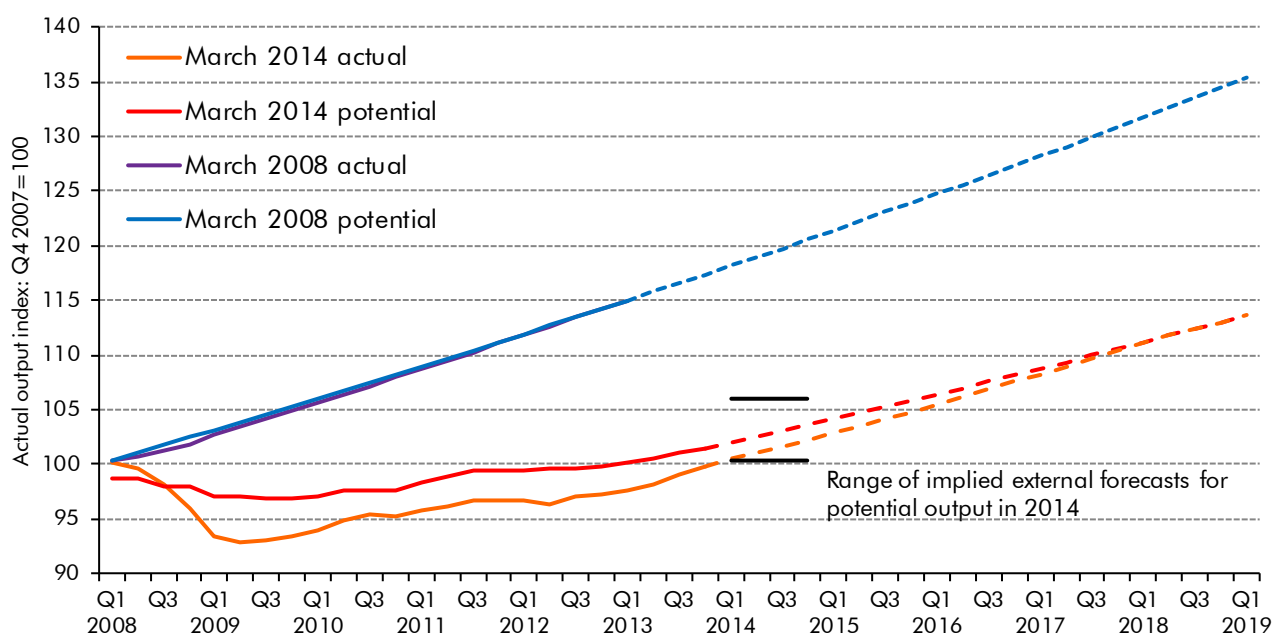


Source ONS, OBR

- 1.10 Some of the fiscal consequences would have been inevitable under any realistic set of policy settings. For example, cash tax receipts are bound to fall when nominal GDP falls, as most taxes are levied on some portion of nominal income or expenditure. Similarly, cash spending on welfare is bound to increase when unemployment rises.
- 1.11 But some of the increase in the deficit reflects the way in which the unusual behaviour of the economy in recent years has interacted with long-standing features of tax and spending policy that normally help to keep government borrowing under control. These include the setting of multi-year cash plans for spending on public services and capital investment, as well as the convention that tax allowances, tax thresholds, benefits and public service pension payments rise in line with some measure of consumer price inflation unless policymakers explicitly choose otherwise. The more generous 'triple lock' convention for the uprating of state pension payments is a more recent long-term policy setting.

- 1.12 Under normal circumstances – when nominal wages rise faster than consumer prices, nominal GDP rises as fast as nominal wages, and all of them are relatively predictable – these policy settings generally help to keep government borrowing in check. They increase tax receipts and reduce welfare spending as a share of GDP over time, while helping the Treasury to resist political and other upward pressures on public services spending.
- 1.13 But in an environment in which earnings growth and nominal GDP growth are very weak – relative to both consumer price inflation and previous expectations – the opposite is the case. Multi-year cash spending plans that were designed to reduce spending slightly as a share of GDP suddenly imply a sharp increase. Fiscal drag moves into reverse, as falling real wages pull people’s incomes into lower tax brackets and reduce the effective tax rate. Maintaining the purchasing power of benefits relative to consumer prices increases them relative to the earnings of people in work and relative to the size of the economy that has to finance them. And the triple lock – which, together with population ageing, puts upward pressure on pension spending in any event – suddenly does so with a vengeance.
- 1.14 If the ballooning of the budget deficit simply reflected the fact that nominal GDP and asset markets had fallen a long way below the paths anticipated for them prior to the crisis – and that in time they could be expected to return to those paths – then there would be no compelling case for a large-scale fiscal consolidation to return the budget deficit to its pre-crisis level, although debt interest costs could be higher for a significant period.
- 1.15 The case for the consolidation – accepted by both the previous and current Governments, albeit with disagreement about its size and pace – is that the potential level of GDP that the economy can sustain, consistent with meeting the inflation target, is likely to be permanently lower than people thought prior to the crisis. Our latest forecast assumes that potential GDP was around 12½ per cent lower than the Budget 2008 forecast by 2012-13 and that it will be 16 per cent below an extrapolation of that forecast by 2018-19. Even the most optimistic external assessments lie well below an extrapolation of the Budget 2008 forecast.

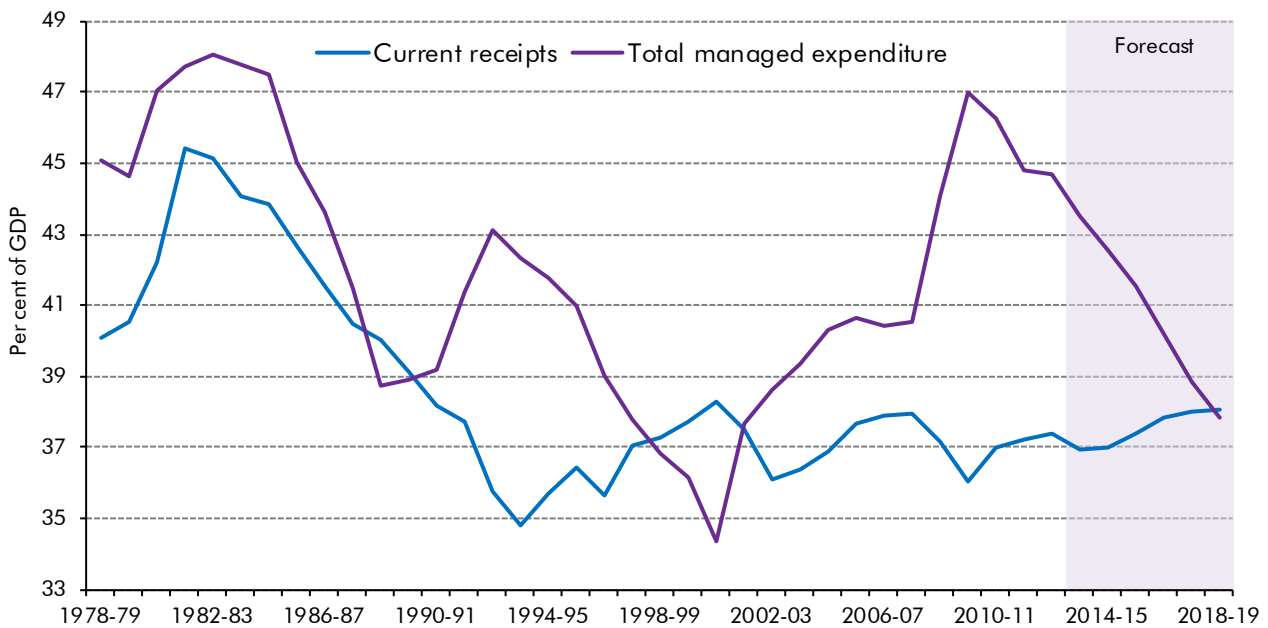
Chart 1.2: Actual and potential GDP forecasts: March 2008 and March 2014



Source: HM Treasury, OBR

- 1.16 When potential output is lower, there is less scope for economic activity to recover. And this in turn implies that there is less scope for tax receipts to rebound and for welfare costs to subside. As a result the underlying 'structural' budget deficit that remains when economic activity returns to its full potential is bigger. Our latest forecast implies that the underlying structural budget deficit in 2012-13 was around 8½ per cent of GDP bigger than was forecast in Budget 2008. The Coalition Government is currently aiming to fill this hole – and to eliminate the structural deficit it inherited – so that the budget gets back to balance overall in 2018-19.
- 1.17 In order to achieve this, the current and previous Governments have announced spending cuts and tax increases that will be worth slightly more than 10 per cent of GDP by 2018-19, relative to the policies that were in place at Budget 2008. On our forecasts this would be sufficient to eliminate the 11 per cent of GDP budget deficit recorded in 2009-10 and move to a small surplus of 0.2 per cent in 2018-09, helped by the absorption of the remaining cyclical element of the deficit. About 50 per cent of the fiscal consolidation had been delivered by 2013-14, achieving about 40 per cent of the total planned deficit reduction.

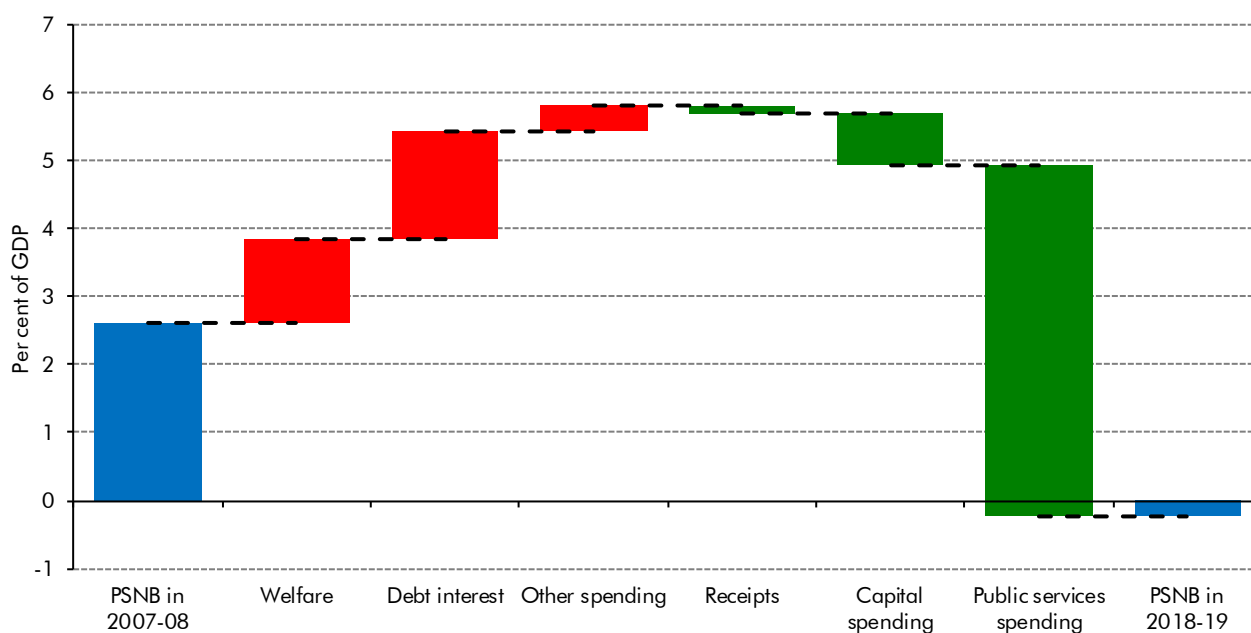
Chart 1.3: Total public spending and receipts: March 2014 forecast



Source: ONS, OBR. Excludes Royal Mail and APF transfers.

1.18 On current plans, the burden of the fiscal consolidation – especially that part which has yet to be delivered – falls very heavily on cuts in day-to-day spending on public services. By 2018-19, the Coalition Government is planning to replace the 2.6 per cent of GDP budget deficit that Labour ran in in 2007-08 with a 0.2 per cent of GDP surplus, to spend 1.2 per cent of GDP more on welfare, 1.6 per cent of GDP more on debt interest and 0.4 per cent of GDP more on other annually managed expenditure, such as public service pensions. To pay for this, it plans to raise just 0.1 per cent of GDP more in revenue (with most of its tax increases used to pay for other tax cuts and to cover the loss of receipts from areas like the financial sector and the North Sea), 0.7 per cent of GDP from cuts in capital spending (which require it to be cut by almost a third) and 5.2 per cent of GDP from cuts in the day-to-day costs of public services, mostly public sector pay and procurement.

Chart 1.4: Sources of the change in borrowing between 2007-08 and 2018-19



Source: ONS, OBR. (2018-19 figures adjusted for effect of reforms to council tax benefit and business rates)

- 1.19** Adjusting for whole economy inflation, on these plans real per capita spending on public services would be cut by 23 per cent between 2007-08 and 2018-19, while real per capita GDP increases by 3½ per cent. This would reduce spending on public services and administration probably to its lowest share of GDP at least since 1948 – and on some data the lowest since 1938. That said, adjusted for the (highly uncertain) estimate of inflation in government consumption in the National Accounts, real per capita spending on public services would still be twice as high as in 1948 and perhaps only at its lowest since 2003.
- 1.20** By the time that the budget is balanced again, receipts and spending would both be around 38 per cent of GDP. As it happens, this is very similar to their levels when the budget was last close to balance in 2001-02. But the composition of public spending will look very different – around 4 per cent of GDP more on welfare, debt interest and other annually managed expenditure broadly offset by less on public services and capital spending.¹ The composition of receipts will be different too – 2.6 per cent of GDP more from income taxes, VAT, capital taxes and other receipts, and 2.0 per cent of GDP less from corporation tax (both onshore and North Sea), fuel duty, other excise duties and business rates.
- 1.21** So is this how things are going to turn out? There are considerable uncertainties around any forecast for the public finances, both about how the economy will perform and, over and above that, about how receipts and spending will perform in any given state of the economy. Our forecasts are also based – as Parliament requires – on the current policies of the current government. And those policies could change.

¹ Over this longer period, not all spending categories are precisely comparable, so these changes should be considered in broad terms.

- 1.22 One important but unanswerable question is whether there will be evidence that the 'hole' in the public finances is larger or smaller than currently estimated, because potential GDP looks lower or higher than currently estimated. This could prompt a change in policy.
- 1.23 And, of course, policy could change even if the economy and the public finances evolve exactly as we forecast. Indeed, the two member parties of the Coalition have already said that they would follow different policies if each was to govern alone. The Conservatives have said that they would look to cut welfare spending by more, so that they could cut public services by less. And the Liberal Democrats have said that they would be willing to borrow more to finance capital spending that would increase growth, and also to increase taxes on the relatively well off (e.g. via a 'mansion tax'). Labour has said that it would *"balance the books and deliver a surplus on the current budget and falling national debt in the next Parliament. How fast we can go will depend on the state of the economy and the public finances we inherit"*. Parliament has instructed us to not to evaluate alternative policies, and in any event these have not yet been set out in sufficient detail to do so. But, as the General Election approaches, the parties will doubtless be pressed for more detail of their plans.

2 The pre-crisis picture

- 2.1 The financial crisis and recession of 2008 and 2009 – and the dramatic deterioration in the public finances that accompanied it – were in sharp contrast both to the apparent stability of the previous decade and to the relatively benign forecasts that most economists were making even as the crisis began to unfold.
- 2.2 In this chapter we set the scene for our discussion of the impact of the crisis and subsequent fiscal consolidation on the public finances by summarising their evolution over the preceding decade, as well as the official forecasts published in the final ‘pre-crisis’ Budget of March 2008.¹

The pre-crisis decade

- 2.3 Shortly after defeating the Conservatives and coming into office in 1997, the newly elected Labour Government complained that:

“On arrival in office the Government was faced with a large structural fiscal deficit, low net investment, rising public debt and falling public sector net worth. Urgent action was needed. This situation had come about in part as a result of a lack of clear and transparent fiscal objectives, together with fiscal reporting that did not permit full and effective public and Parliamentary scrutiny.”²

- 2.4 In response, it set out a new fiscal framework comprising two main elements:

- first, the *Code for fiscal stability*, which set out five broad principles for fiscal policy, as well as requiring the Treasury to be transparent about its goals and record; and
- second, two specific fiscal rules, namely:

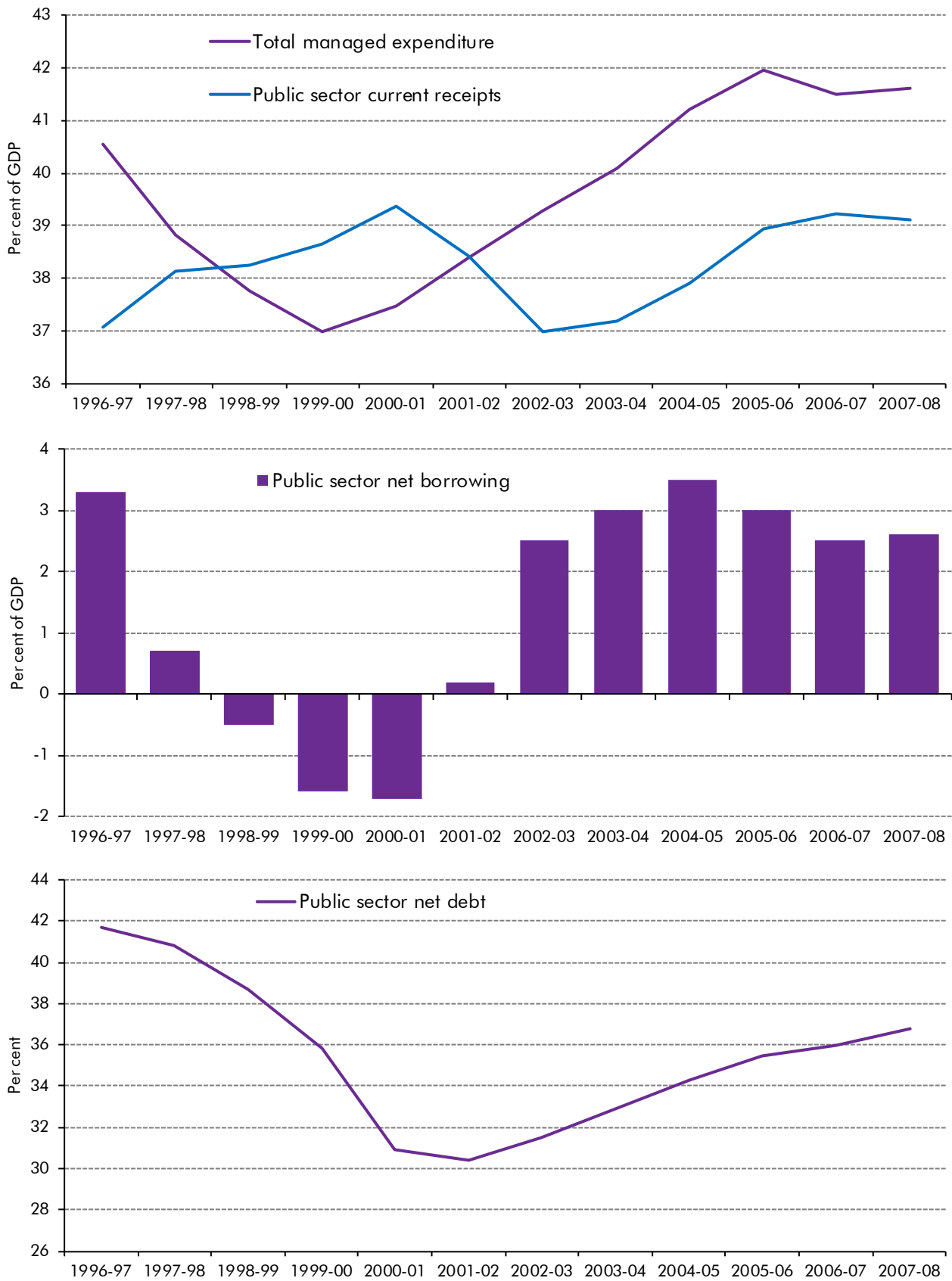
the **golden rule**, which required the Government to borrow only what it needed to pay for capital investment – in other words, to keep the current budget in balance or surplus – on average over the economic cycle; and

the **sustainable investment rule**, which required the Government to keep the public sector’s debt (net of its short-term financial assets) at a ‘stable and prudent’ level. The Treasury later defined this as less than 40 per cent of national income (GDP) at the end of each financial year of the economic cycle.

¹ We are very grateful to Alistair Darling, Chancellor of the Exchequer at the time, for his permission to publish the Budget 2008 economic and fiscal forecasts to the same degree of detail and over the same time horizon as our own *Economic and fiscal outlook* forecasts.

² Page 7 of HM Treasury, *Analysing UK fiscal policy*, November 1999.

Chart 2.1: Summary of the public sector finances: the pre-crisis decade

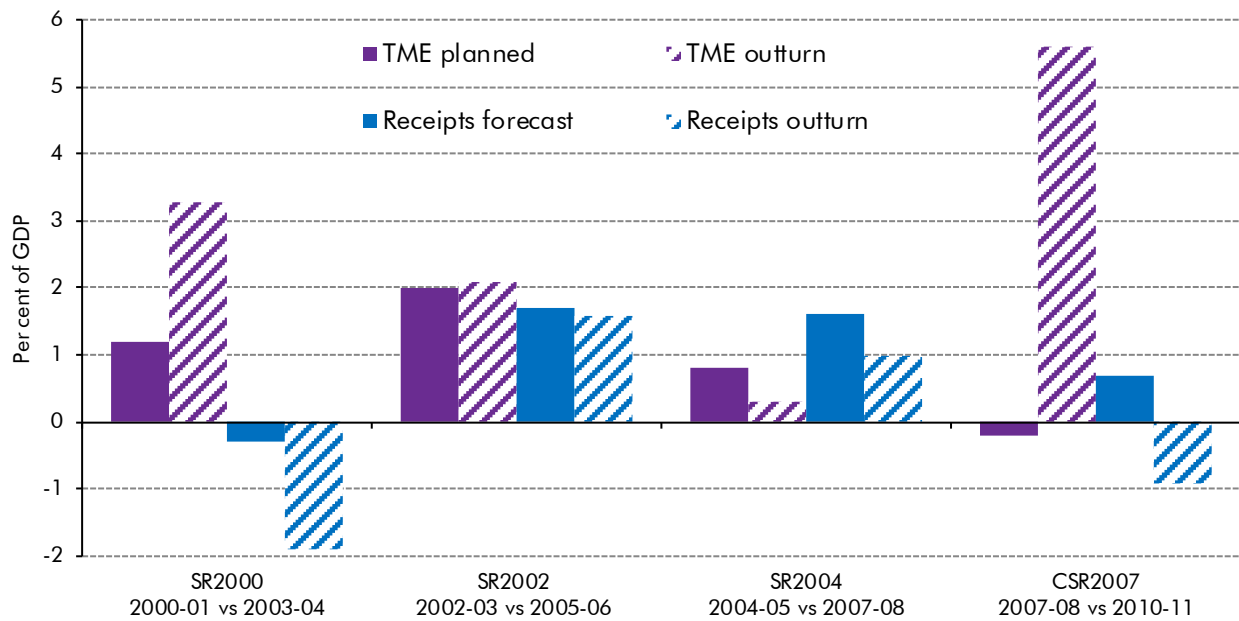


Source: ONS

2.5 The performance of the public finances during the pre-crisis decade is summarised in Chart 2.1. It can be divided into four broad phases:

- first, the move from a budget deficit to a surplus during Labour's first term. The incoming Government helped bring this about by maintaining and extending the planned public spending cuts it inherited from the Conservatives. On the tax side, it introduced a windfall tax on privatised utilities and abolished payable tax credits to pension schemes. Meanwhile, revenues were supported by above-average growth in real and nominal GDP and by rising employment, while modest inflation rates and improving labour market conditions restrained welfare bills. The move into surplus and falling gilt yields lowered debt interest payments. As the budget balance improved, so public sector net debt fell towards 30 per cent of GDP – aided in 2000-01 by the £22.5 billion proceeds of the 3G-spectrum licence auction;
- second, a return to deficit over the first two years of Labour's second term. In its 2000 Spending Review, the Government announced multi-year increases in public spending (mainly on tax credits, education and the NHS), assuming as it did so that the recent improvement in the public finances had been structural. Unfortunately, this coincided with the bursting of the dotcom bubble in late 2000. Growth in real and nominal GDP slowed, reducing income tax and onshore corporation tax receipts. The drop in revenues was exacerbated by the impact of falling share prices on financial sector profits and salaries, and by the effect of higher oil prices on the non-oil economy. This outweighed higher receipts from North Sea taxes and from stamp duty land tax as house prices increased by 10 per cent a year. As the budget deficit re-emerged, net debt began to rise as a share of GDP from 2002-03;
- third, the deficit then remained relatively stable at around 3 per cent of GDP between 2002-03 and 2005-06, with net debt drifting upwards. The 2002 Spending Review promised further spending increases to correct the *"decades of chronic and persistent under-investment in education, health, transport and housing"*. This was going to be financed by a 1.7 per cent rise in the receipts to GDP ratio, as shown in Chart 2.2. But the increase in spending was slightly larger than expected over these three years, and the increase in receipts slightly smaller, so the deficit did not fall as quickly as expected; and
- fourth, spending and receipts then stabilised as shares of GDP until the crisis – leaving the deficit stuck at around 2½ per cent of GDP. The 2004 Spending Review announced further increases in spending on public services – again to be financed by an increase in receipts that did not fully materialise. After the 2005 election, it had looked likely that the Government would breach its 'golden rule' on existing policies – and in autumn 2005 it announced fresh tax increases and reduced the projected rate of future public spending growth. In Budget 2008, the Government declared that its fiscal rules had been met by a narrow margin over what it judged to be an economic cycle running from 1997-98 to 2007-08 – with the current budget averaging a surplus of 0.1 per cent of GDP and public sector net debt forecast to reach 39.3 per cent of GDP in 2012-13.

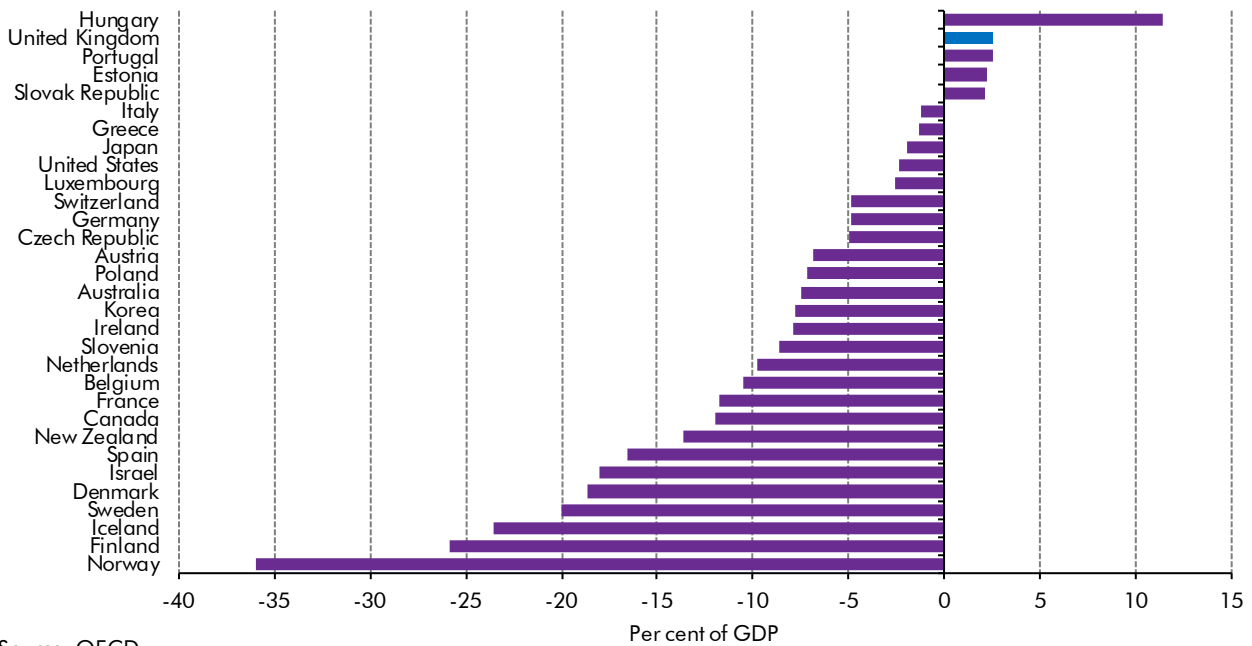
Chart 2.2: Spending and receipts in successive Spending Review periods



Source: HM Treasury

2.6 With deficits ranging between 2½ and 3½ per cent of GDP between 2002-03 and 2007-08 – rather than shrinking toward 1 per cent as intended – outturns and forecasts for the ratio of public sector net debt to GDP were pushed steadily higher. Net debt did remain below the Government’s target ceiling of 40 per cent of GDP until the crisis, but the increase in debt towards that ceiling occurred at a time when most other industrial governments were reducing their debt ratios. Indeed, as Chart 2.3 illustrates, the UK was one of only five OECD countries to record an increase in general government net liabilities as a share of GDP between 2004 and 2007. In some cases, countries were explicitly attempting to ‘pre-fund’ expected upward pressure on public spending from the ageing of their populations.

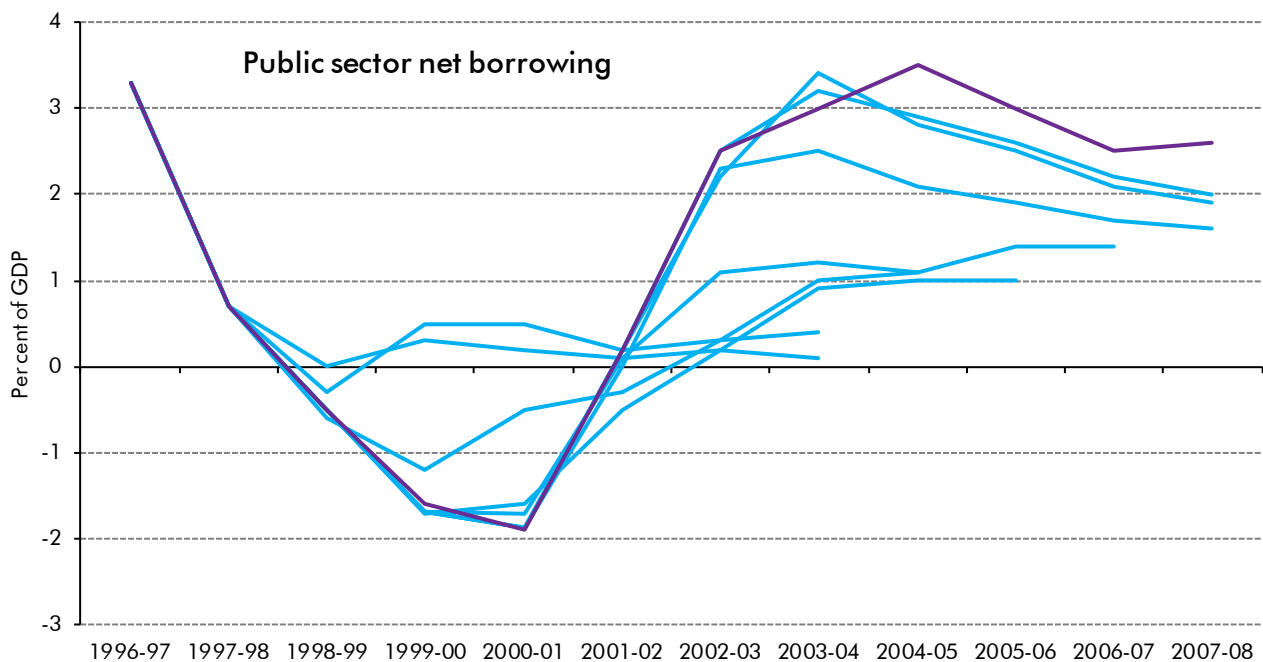
Chart 2.3: Changes in general government net liabilities from 2004 to 2007



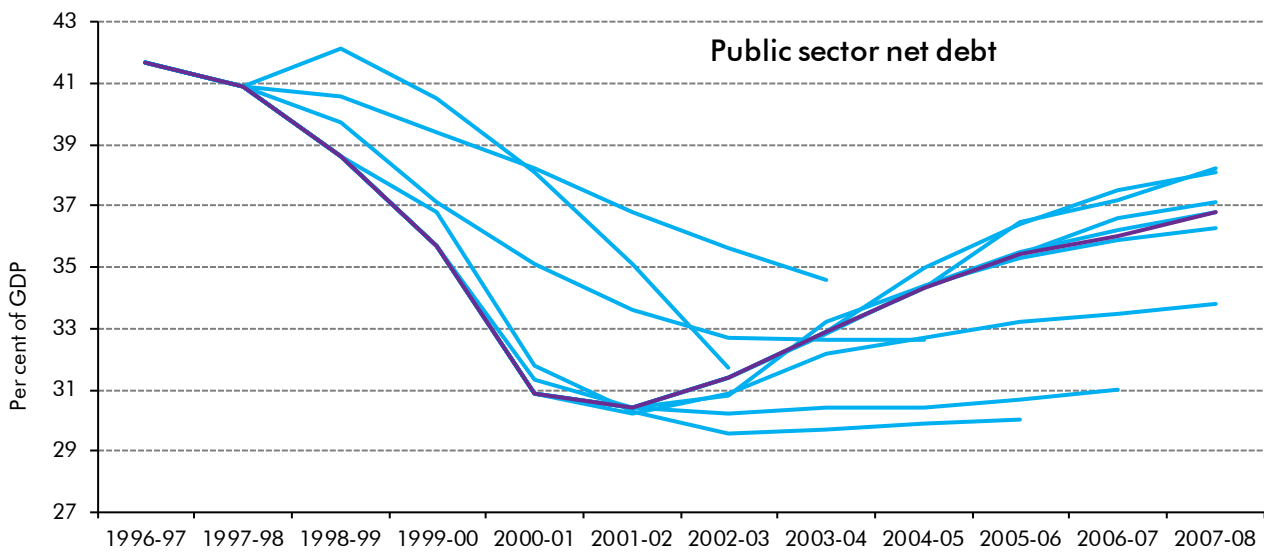
The performance of the public finances forecasts

2.7 Charts 2.4 and 2.5 show the evolution of the Government’s Budget forecasts for public sector net borrowing and net debt during the pre-crisis decade. The patterns reflect the evolution of the public finances described above. The Government initially underestimated both the speed and size of the swing from deficit to surplus in its first term, and then the size of the deficits that it would run over the rest of the pre-crisis decade.

Chart 2.4: Budget forecasts for public sector net borrowing and net debt



The pre-crisis picture

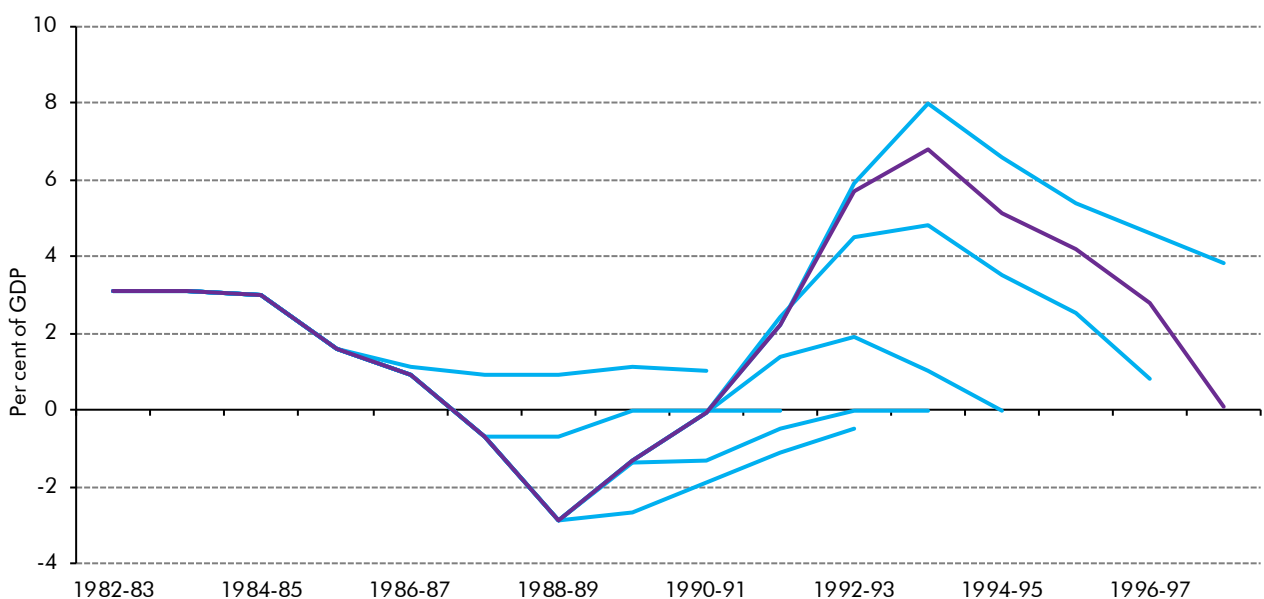


Source: HM Treasury, ONS

Notes: Outturns for Budget 2008 and subsequent forecasts exclude financial interventions. Since Budget 2008 there have been upward revisions to outturn nominal GDP; data used in these charts is based on the position as understood at Budget 2008. The impact of the 3G spectrum auction (£22.5 billion or 1.8 per cent of GDP) is excluded in the 2000-01 figures.

2.8 This pattern of unexpected surpluses followed by unexpectedly large deficits was similar to that seen under the previous Conservative Government from 1987 to 1993. The then Government loosened fiscal policy in response to what it saw as an increase in trend growth, which was expected to bolster receipts. In hindsight, the structural position was much weaker than it believed at the time, which resulted in consistently overoptimistic fiscal forecasts in successive Budgets. The new fiscal framework introduced by the Labour Government was supposed to reduce the risk of making this type of error.

Chart 2.5: Budget forecasts for public sector net borrowing



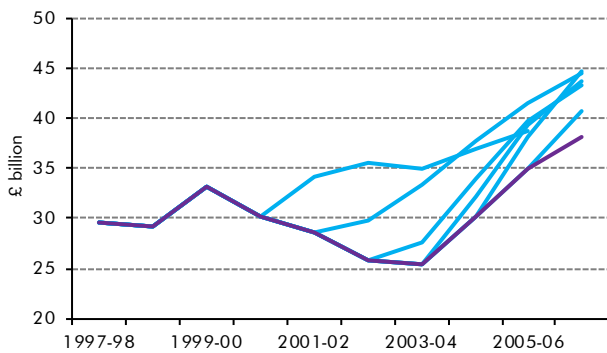
Source: HM Treasury, ONS

Note: Prior to 1994, public sector borrowing requirement (now renamed public sector net cash requirement) was used as the official measure of borrowing rather than public sector net borrowing

2.9 The pre-crisis forecasts for net borrowing were over-optimistic primarily because of the forecasts for corporation tax and income tax receipts:

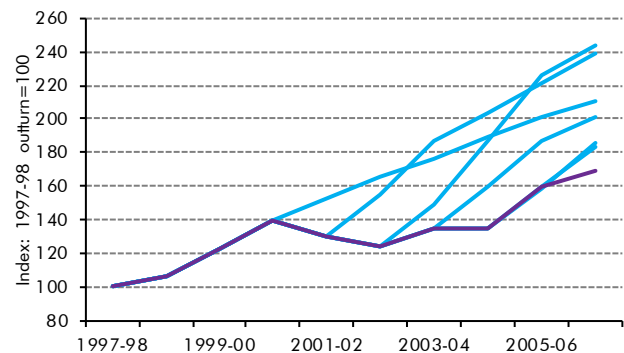
- between 2001 and 2006, Budget forecasts for corporation tax overestimated receipts by an average of £3.5 billion one-year ahead and £6.8 billion two-years ahead (Chart 2.6). In particular, this reflected overoptimistic forecasts for financial sector profits (Chart 2.7). The forecasts were consistently optimistic throughout the 2000s, with receipts falling as the dotcom bubble burst and then failing to rebound as expected; and

Chart 2.6: Corporation tax forecast errors



Source: HM Treasury, HMRC

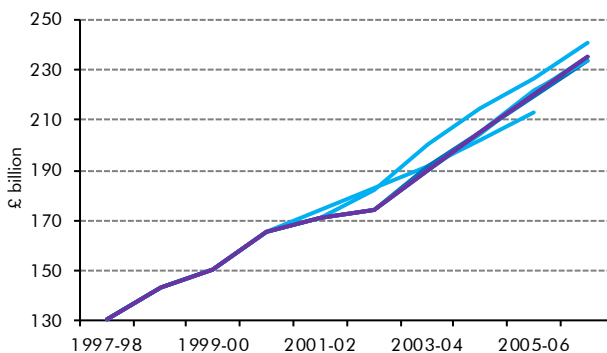
Chart 2.7: Financial company profit growth forecast errors



Source: HM Treasury, HMRC

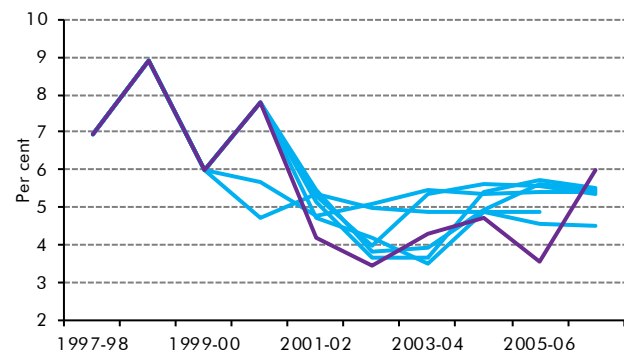
- income tax and NICs receipts were overestimated primarily in the early part of the decade (Chart 2.8), largely reflecting overoptimistic forecasts for wages and salaries (Chart 2.9). The Budget 2001 and 2002 forecasts overestimated receipts by an average of £5.4 billion one-year ahead and £6.2 billion two-years ahead. These were comparatively big forecast errors at the time, although they have since been dwarfed by those associated with the crisis. The tax take from financial sector bonuses was also overestimated due to the fall in bonuses in both 2001-02 and 2002-03.

Chart 2.8: Income tax and NICs forecast errors



Source: HM Treasury, HMRC

Chart 2.9: Wages and salaries growth forecast errors

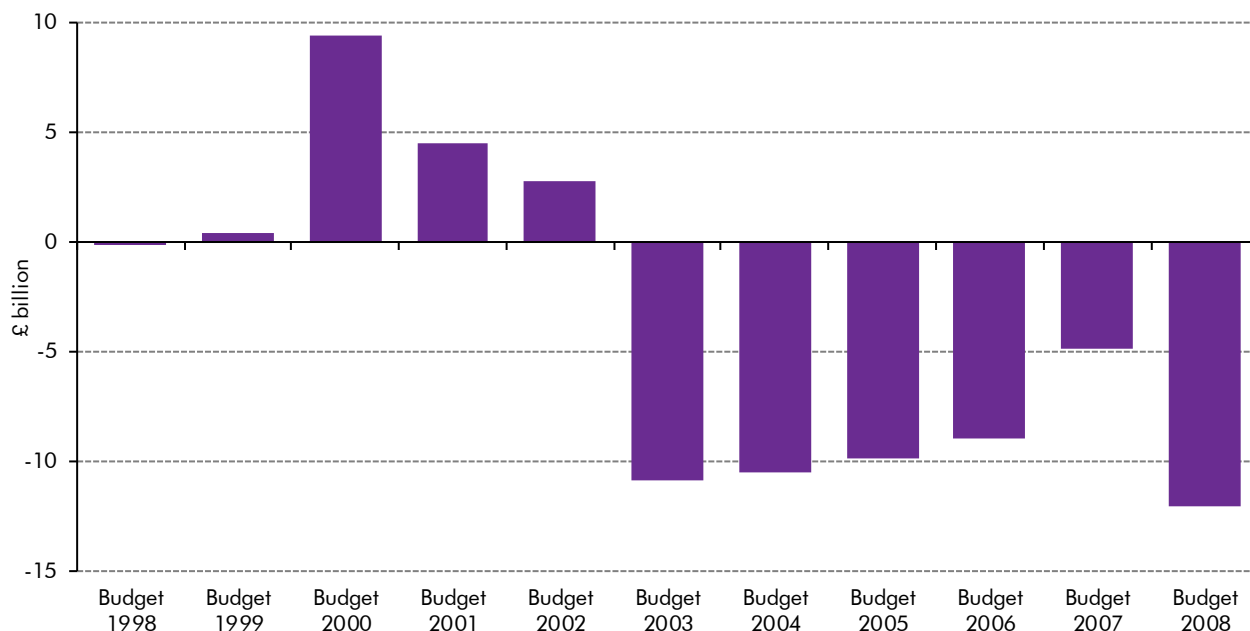


Source: HM Treasury, ONS

The pre-crisis picture

- 2.10 Very little detail of these forecasts was published at the time – income tax and corporation tax forecasts in cash terms were only published for the first two years of the forecast period while forecasts for key determinants such as wages and salaries and the profits of financial and non-financial companies were not published at all.
- 2.11 Most outside forecasters predicted at the time that receipts would not pick up as quickly as the Government was hoping and that borrowing would be higher than expected. Chart 2.10 shows the gap between Government forecasts for net borrowing four years ahead at each Budget and the average external forecast at the same time. It shows that from Budget 2003 onwards, external forecasters were on average almost £10 billion more pessimistic than the Government about the budget deficit over this horizon.

Chart 2.10: Gap between Government and contemporaneous average external forecasts for public sector net borrowing four years ahead



Source: HM Treasury

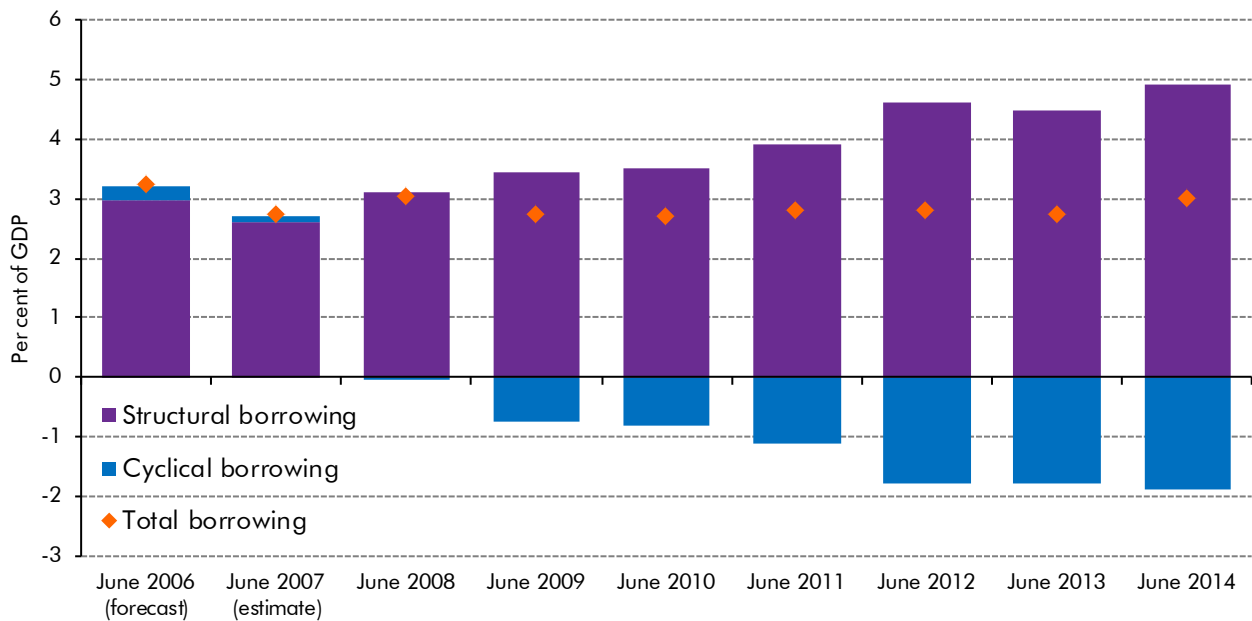
The structural health of the public finances

- 2.12 Headline levels of public spending and receipts – and therefore the size of the budget deficit – are automatically influenced by the state of the economy. When the economy is strong, receipts are boosted and welfare spending subdued, so the deficit is smaller; when the economy is weak, receipts are depressed and welfare spending increased, so the deficit is larger. One way to assess the underlying health of the public finances is to estimate the ‘structural’ or ‘cyclically adjusted’ deficit, in other words the deficit you would expect to see if activity was at its sustainable ‘potential’ level consistent with maintaining stable inflation. You would expect the economy to tend to this level of activity over time as the Bank of England sets monetary policy to achieve the inflation target it has been given. As it does so, any cyclical deficit or surplus should be eliminated, leaving only the structural component.

- 2.13 At each Budget and Pre-Budget Report from late 2002, the Government forecast an improvement in the structural budget balance over the forecast period. The forecasts typically predicted cyclically adjusted net borrowing of around 1½ per cent of GDP at the end of the five-year forecast period and (excluding borrowing to finance investment) a cyclically-adjusted current budget surplus of around ¾ per cent of GDP. This was consistent with public sector net investment of 2¼ per cent of GDP. As with the overall budget deficit, these forecast improvements failed to materialise. In general, the return to the desired medium-term structural balance had to be delayed by a further year each year.
- 2.14 The Government's confidence prior to the crisis that the headline budget deficit would narrow over the medium term in part reflected its belief that activity in the economy was running at or below its sustainable level, holding out the prospect of at-or-above-trend rates of growth for a while, with beneficial consequences for receipts and spending. But, with the benefit of hindsight, many economists now believe that activity in the economy was running above its sustainable level in the run-up to the crisis. This implies that the structural deficit was larger than the headline deficit and larger than was appreciated at the time.
- 2.15 For example, in Budget 2006 the then Government estimated that public sector net borrowing in 2006-07 was 2.8 per cent of GDP, but that the economy was running 1.4 per cent below potential. This implied a more modest structural deficit of 1.9 per cent of GDP, as the headline deficit would have shrunk automatically as spare capacity was absorbed by above-trend growth. As of Budget 2014, we estimate that the headline deficit in 2006-07 was 2.5 per cent of GDP, slightly smaller than in Budget 2006 (in large part because the level of GDP has been revised higher). But we also estimate that the economy was running 0.8 per cent *above* potential in 2006-07, giving a structural deficit of 3.2 per cent of GDP.
- 2.16 A similar pattern can be seen in other institutions' forecasts and estimates. Chart 2.11 shows successive June Economic Outlook forecasts and outturn estimates for the total, cyclical and structural budget deficit³ in 2007 by the Organisation for Economic Cooperation and Development (OECD). On the OECD definition, the estimated headline deficit in 2007 has been close to 3 per cent of GDP in each publication. But between June 2007 and June 2014, it has revised its estimate of the output gap in 2007 from a small negative gap of -0.2 per cent of potential GDP to a large positive gap of 4.9 per cent. As a result, it has almost doubled its estimate of the structural deficit that year from 2.6 per cent of GDP to 4.9 per cent.

³ The OECD's forecasts refer to 'general government net lending', a slightly narrower definition of the budget deficit than public sector net borrowing used in our forecasts and in the Treasury's forecasts prior to the creation of the OBR.

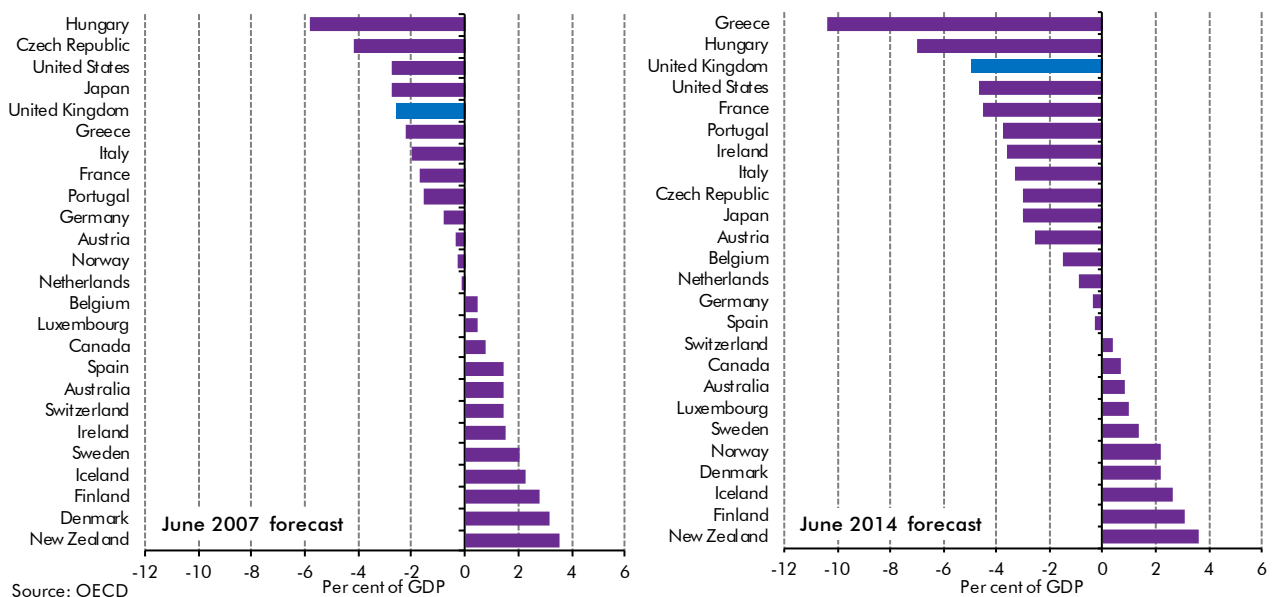
Chart 2.11: OECD forecasts and estimates for net borrowing in 2007



Source: OECD

2.17 As Chart 2.12 illustrates, the OECD now estimates that the UK had the third largest structural deficit among its member countries in 2007, exceeded only by Greece and Hungary; in June 2007, it estimated the UK had the fifth largest structural deficit, exceeded also by the US and Japan. The OECD has now concluded that the structural budget balance was weaker in most countries immediately prior to the crisis than it thought at the time (dramatically so for Greece).

Chart 2.12: OECD structural deficit estimated for 2007



Source: OECD

- 2.18 But we should be slightly wary of this ex post re-estimation. Many estimates of potential GDP in effect trace a smoothed line through the path of actual GDP – either directly through statistical filtering or indirectly through a so-called ‘production function’. When a period of strong growth in actual GDP is followed by much weaker growth or an outright fall, the estimate of potential GDP at and just before the turning point will automatically be revised lower as the period of weak growth lengthens and drags the estimated path of potential lower. This makes the output gap more positive (or less negative) ahead of the turning point and increases the estimated structural component of the budget deficit at the time. But if the method of estimating potential output allows the trend to change abruptly – perhaps consistent with a sudden dislocation in the financial system – this need not be the case.⁴
- 2.19 That said, even the real-time estimates of the structural deficit were large enough for the international institutions to recommend that steps be taken to reduce it:

“In another four European Union countries (Italy, the United Kingdom, Greece and France) the projected deficit, while remaining below 3 per cent of GDP, is well beyond the safe budget margins which might reasonably be expected to ensure that the 3 per cent deficit limit would be respected in the face of a major cyclical downturn.” (OECD Economic Outlook, June 2007)

“Convergence between the authorities’ and the staff’s views is high. Planned fiscal consolidation should halt the increase in public debt, and staff emphasizes the desirability of holding the fiscal deficit down after this adjustment so as to increase scope for fiscal stabilizers.” (IMF Article IV consultation, March 2007)

Budget 2008: the final pre-crisis forecast

- 2.20 Notwithstanding the bursting of the dotcom bubble – and the fall in the ratio of receipts to GDP that followed it – the decade prior to the financial crisis was one of relative stability for both the economy and the public finances, compared to the decades that preceded it. Stability in GDP growth and inflation was accompanied by rapid growth in asset prices and private sector debt-to-income ratios, developments that some economists (especially with hindsight) believe should have been seen as warning signs. But, right up to the brink of the crisis, most forecasters expected the relative stability to be sustained.
- 2.21 In the next chapter, we examine the performance of the economy and the public finances relative to pre-crisis expectations. To do this, we use Alistair Darling’s March 2008 Budget forecast as our ‘pre-crisis’ baseline. In some respects the crisis was already well under way by March 2008: Northern Rock had been nationalised some weeks beforehand (following the run on the bank in the previous September); the collapse of Bear Stearns was only days away; UK house prices had started to fall and real GDP had already reached its peak (although that was not apparent at the time). But with the defining collapse of Lehman

⁴ For a fuller discussion of methodologies deployed in estimating output gaps, see *Working Paper No 5 – Output gap measurement: judgement and uncertainty* available on our website.

Brothers still some months away, the difficulties in the financial sector were still expected to have only a modest and short-lived impact on the economy and public finances.

The Budget 2008 economy forecast

- 2.22 In Budget 2008, real GDP growth was expected to slow from 3 per cent in 2007 to 2 per cent in 2008, before recovering to 2½ per cent in 2009 (although the Treasury assumed growth rates a quarter of a point lower in each case in its fiscal forecasts). As Mr Darling put it in his Budget speech: *“Because of the changes made by this Government to entrench stability and increase the flexibility and resilience of our economy, I am able to report that the British economy will continue to grow through this year and beyond.”*
- 2.23 The forecast assumed that potential GDP growth would remain steady at 2¾ per cent a year (2½ per cent for the fiscal forecast). With the slowdown in the economy during 2008, the forecast assumed that activity would fall 0.5 per cent below its potential level in 2008-09. Growth was then expected to rebound fractionally above its trend rate, sufficient to absorb this spare capacity by the forecast horizon. The forecast for nominal GDP followed a similar path, with a slowdown in 2008-09, followed by growth of around 5¼ per cent a year over the rest of the forecast period. The three drivers of the largest tax bases – wages and salaries, profits of industrial and commercial companies, and nominal consumer spending – were all expected to grow at a similar rate to overall nominal GDP from 2009-10 onwards.
- 2.24 By Budget 2008, there had been a drop in equity markets and a slowdown in the financial sector. But, as noted in Budget 2008, *“...the forecast assumes the disruption in financial markets will have a larger impact on receipts in 2008-09 than in 2007-08. Thereafter, financial sector profits are projected to recover as financial markets are assumed to normalise.”*⁵ The forecast assumed growth in financial sector profits of over 50 per cent between 2007-08 and 2012-13. The forecast also locked in the relatively high pre-crisis levels of house prices and transactions. House prices were expected to be broadly flat in the near term, before rising in line with earnings towards the end of the forecast period.
- 2.25 Consumer price inflation was expected to rise to just under 3 per cent in 2008 before returning to and remaining at the Bank of England’s 2 per cent target. The forecast assumed that oil prices would average \$83.8 a barrel in 2008 – the average of independent forecasts at the time – and then remain constant in real terms.

⁵ Budget 2008, Annex C, paragraph C55.

Table 2.1: Economic determinants for the fiscal forecast: Budget 2008

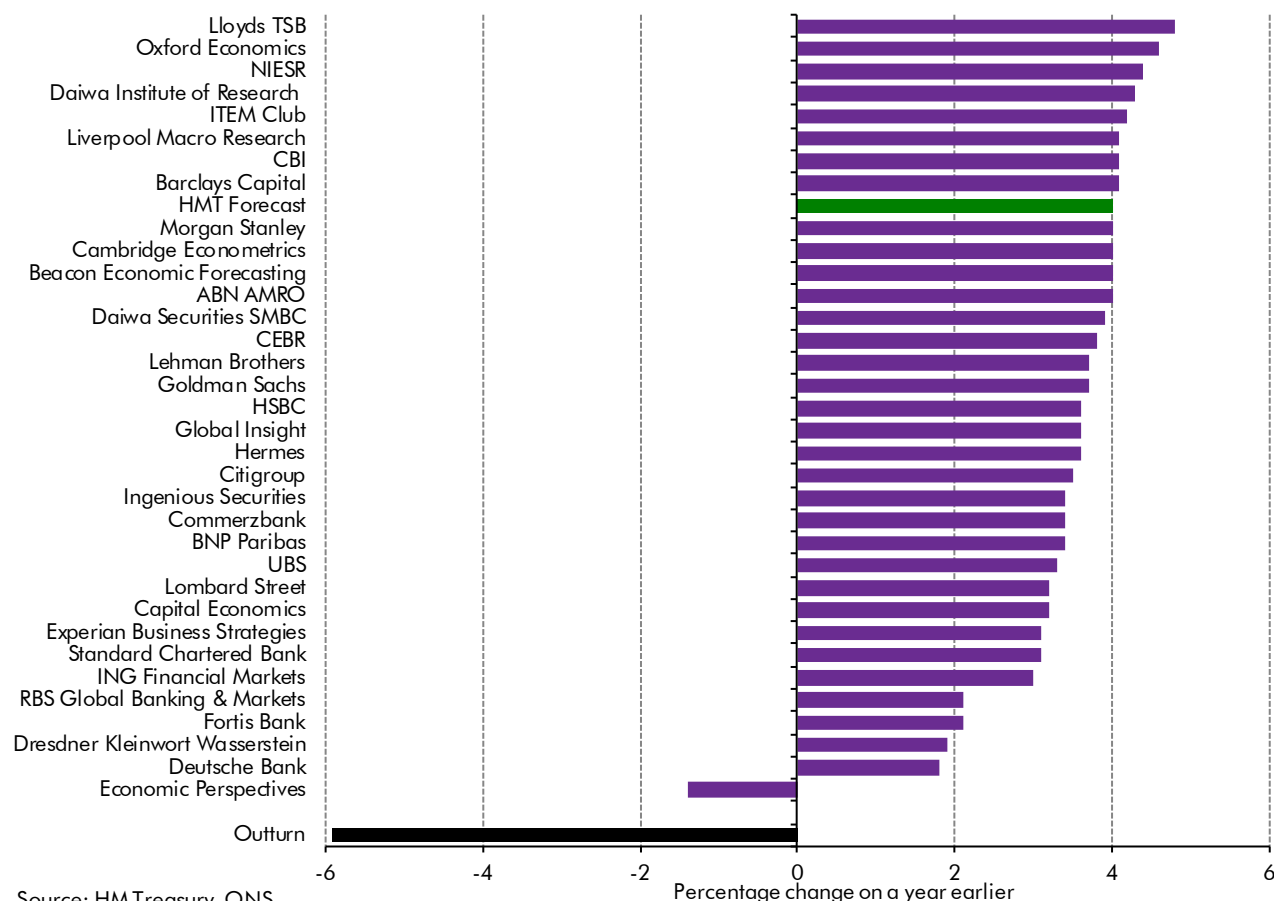
	Percentage change on previous year unless otherwise specified						2007-08 to 2012-13
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	
GDP and its components							
Real GDP	3.0	1.7	2.5	2.6	2.6	2.6	12.4
Nominal GDP ¹	6.1	4.8	5.2	5.3	5.3	5.3	28.8
Nominal GDP (£ billion) ^{1,2}	1405	1473	1550	1632	1719	1811	405
Nominal GDP (centred end-March £bn) ^{1,3}	1440	1511	1591	1675	1765	1859	419
Wages and salaries ⁴	4.2	4.7	5.0	5.7	5.4	5.2	28.8
Non-oil PNFC profits ^{4,5}	11.6	5.6	5.1	5.3	5.3	5.3	29.6
Consumer spending ^{4,5}	5.8	4.7	5.0	5.1	5.1	5.1	27.6
Prices and earnings							
GDP deflator	3.2	3.1	2.7	2.7	2.7	2.7	14.6
RPI (September)	3.9	3.4	2.2	3.1	2.9	2.8	15.3
CPI (September)	1.8	2.9	2.1	2.0	2.0	2.0	11.5
Average earnings ⁶	3.3	4.0	4.8	5.1	4.9	4.7	25.7
Key fiscal determinants							
Claimant count (millions)	0.8	0.9	0.9	0.9	0.9	0.9	0.0
Employment (millions)	29.3	29.5	29.6	29.7	29.9	30.0	0.7
VAT gap (per cent)	14.9	15.2	15.6	16.1	16.7	17.2	2.3
Output gap (per cent of potential output)	0.3	-0.5	-0.4	-0.3	-0.1	0.0	-0.3
Financial and property sectors							
Equity prices (FTSE All-Share index)	3242	3042	3201	3370	3550	3739	498
HMRC financial sector profits ^{1,5,7}	4.0	2.0	17.0	6.0	11.0	9.0	53.1
Residential property prices ⁸	9.9	1.0	2.5	5.2	4.8	4.8	19.7
Residential property transactions (000s) ⁹	1709	1559	1767	1839	1870	1891	182
Commercial property prices ⁹	-15.0	-5.0	5.2	5.2	2.7	2.7	10.9
Commercial property transactions ⁹	3.0	0.0	2.0	1.9	1.8	1.8	7.7
Oil and gas							
Oil prices (\$ per barrel) ⁵	72.4	83.8	85.0	86.2	87.6	88.9	16.4
Oil prices (£ per barrel) ⁵	36.2	42.2	43.3	44.8	46.2	47.6	11.4
Gas prices (p/therm) ⁵	32.8	43.7	42.0	44.2	45.7	47.9	15.1
Oil production (million tonnes) ^{5,10}	76.8	71.9	67.8	64.5	61.5	58.3	-18.5
Gas production (billion therms) ^{5,10}	26.4	24.9	23.7	22.1	20.1	19.1	-7.3
Interest rates and exchange rates							
Market short-term interest rates (%) ¹¹	6.0	5.1	4.5	5.0	5.1	5.1	-0.9
Market gilt rates (%) ¹²	4.7	4.9	4.8	4.9	5.0	5.0	0.3
Euro/Sterling exchange rate (€/£)	1.42	1.30	1.28	1.26	1.24	1.23	-0.19

¹ Not seasonally adjusted.² Denominator for receipts, spending and deficit forecasts as a per cent of GDP.³ Denominator for net debt as a per cent of GDP.⁴ Nominal.⁵ Calendar year.⁶ Wages and salaries divided by employees.⁷ HMRC Gross Case 1 trading profits.⁸ Outturn data from ONS House Price Index⁹ Outturn data from HMRC information on stamp duty land tax.¹⁰ Department of Energy and Climate Change (DECC) forecasts available at www.gov.uk/oil-and-gas-uk-field-data¹¹ 3-month sterling interbank rate (LIBOR).¹² Weighted average interest rate on conventional gilts.

The pre-crisis picture

2.26 The Treasury was not alone in its relative optimism on growth prospects. As Chart 2.13 illustrates, only one of the 34 economists asked for their economic growth forecasts by the Treasury in March 2008 – Peter Warburton of Economic Perspectives – predicted a fall in real GDP in either calendar year 2008 or 2009, and even he predicted only a 1.4 per cent cumulative fall over the two years.⁶ The latest data show a fall of 5.9 per cent.

Chart 2.13: Cumulative GDP growth in calendar years 2008 and 2009: forecasts reported to the Treasury in March 2008



2.27 Other official bodies were also relatively sanguine about the financial and economic outlook. The Bank of England said in its May 2008 *Financial Stability Report*: “The most likely outcome for financial stability in the United Kingdom in the period ahead is that conditions improve gradually as measures are taken.”⁷ And the International Monetary Fund said in its April 2008 *World Economic Outlook*: “In the United Kingdom, growth is forecast to slow to 1.6 per cent in 2008, as the lagged effects of the 2007 monetary tightening, a turning in the house price cycle, and the financial turbulence are projected to slow activity, despite monetary policy easing. Only a moderate recovery is foreseen for 2009.”⁸ The IMF predicted a mild recession in the United States, with the rest of the G7 avoiding recession.

⁶ Economic Perspectives had been pessimistic for years prior to the crisis, underestimating GDP growth by an average of 2.7 percentage points in its March forecasts for the year ahead from 2001 to 2006 and predicting falls in GDP in 2002 and 2003 that did not occur.

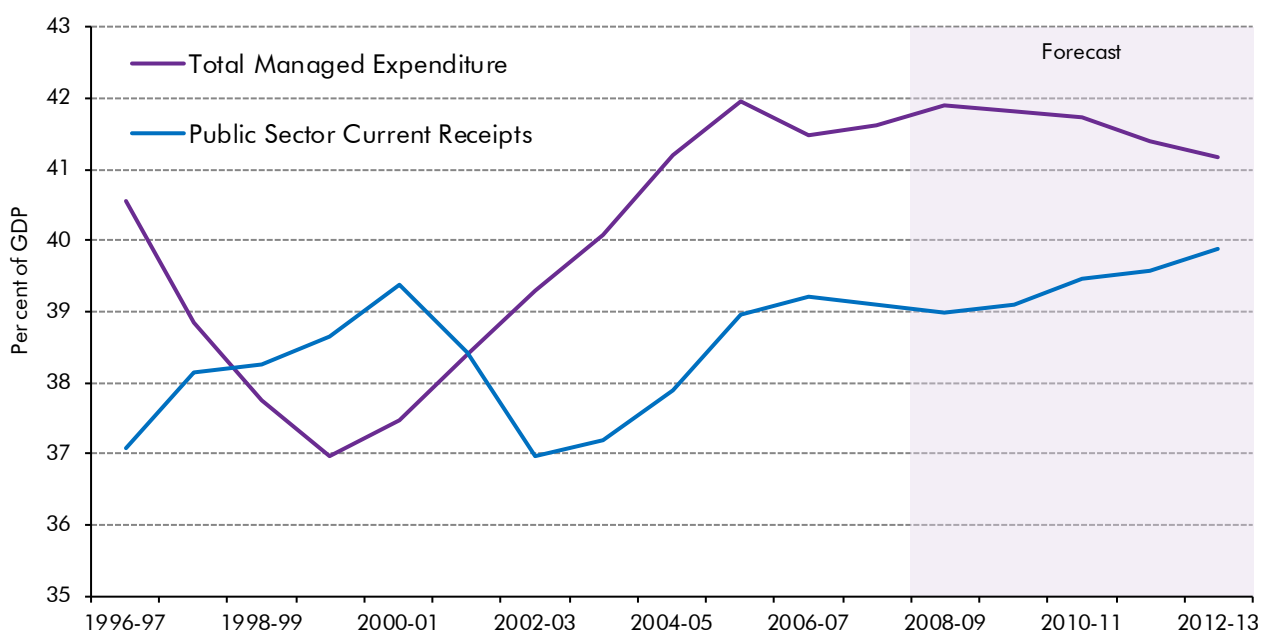
⁷ *Financial Stability Report*, Bank of England, May 2008.

⁸ *World Economic Outlook*, IMF, April 2008.

The Budget 2008 public finances forecast

2.28 So how were the public finances expected to evolve in the March 2008 Budget forecast? Chart 2.14 shows the forecasts for public spending and receipts, alongside what was then thought to have been their path over the previous decade. Budget 2008 predicted that net borrowing would widen from 2.6 per cent of GDP in 2007-08 (the fiscal year just ending) to 2.9 per cent of GDP in 2008-09, before narrowing to 1.3 per cent of GDP by 2012-13. Net debt was expected to rise from 37.1 per cent of GDP in 2007-08 to a peak of 39.8 per cent of GDP in 2010-11, before edging back to 39.3 per cent of GDP by 2012-13.

Chart 2.14: Public sector spending and receipts as forecast in Budget 2008



Source: HM Treasury, ONS

2.29 Given the benign economic forecast, the 0.7 per cent of GDP increase in receipts through to 2012-13 was expected to come primarily from income tax (with real earnings growth increasing the average tax rate through 'fiscal drag') and corporation tax (with financial sector profits recovering). The expected 0.6 per cent of GDP fall in spending reflected the detailed Departmental Expenditure Limits (DELs) for public services and administration set out for 2008-09, 2009-10 and 2010-11 in the 2007 Comprehensive Spending Review (CSR), plus the Government's assumption for total spending growth over the subsequent two years. This was intended to be the toughest spending review to date under Labour, with the Government arguing that the job of addressing the historic lack of 'investment' in public services had been completed. Real growth in DELs was reduced to an average of 2.1 per cent a year over the three CSR years, compared to 4.5 per cent a year over the previous three years (as estimated at the time). In the Budget 2008 forecast, this looked sufficient to reduce total DEL spending by 0.1 per cent of GDP over the CSR years. Welfare spending was also forecast to fall slightly as a share of GDP.

Table 2.2: Summary of Budget 2008 fiscal forecast

	£ billion					
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Public sector current receipts	549.9	575.2	608.2	647.4	682.9	721.1
Total managed expenditure	586.4	617.8	646.5	679.8	710.2	743.8
Public sector net borrowing	36.4	42.5	38.4	32.4	27.3	22.7
Public sector net debt	534	581	627	666	700	731
	Per cent of GDP					
Public sector current receipts	39.1	39.0	39.2	39.7	39.7	39.8
Total managed expenditure	41.7	41.9	41.7	41.6	41.3	41.1
Public sector net borrowing	2.6	2.9	2.5	2.0	1.6	1.3
Public sector net debt	37.1	38.5	39.4	39.8	39.7	39.3

Conclusion

- 2.30 The decade prior to the financial crisis was a relatively benign one for the economy and the public finances, compared to previous decades and to what was to follow. But there were weaknesses and vulnerabilities, some of which were noted at the time.
- 2.31 Having briefly delivered budget surpluses in the early 2000s, the then Government chose to increase public spending as a share of GDP into its second term in the belief that this would be paid for by a rise in receipts as a share of GDP. But – in line with the predictions of many external observers – receipts did not perform as strongly as the Government hoped and in the run-up to the crisis it consistently ran deficits that were larger than forecast and larger than in most other developed economies.
- 2.32 From autumn 2003 onwards, the Government estimated that it was running a structural deficit of 2 to 2½ per cent of GDP at the time of each forecast, and claimed that its policies were consistent with reducing that to around 1½ per cent of GDP over each forecast period. That did not happen and, with the benefit of hindsight, the structural deficit also now appears larger than was estimated at the time. But estimates of the output gap and the split between the cyclical and structural deficit are always highly uncertain, even after the event.
- 2.33 By the spring of 2008, the financial sector was once again in difficulties, triggered in the previous year by developments in the US housing market that sent shockwaves through global financial markets and banking systems. However, the damage to the economy and the public finances was expected to be shallow and short-lived, with real and nominal GDP growth expected to recover in 2009 and the budget deficit to narrow gradually over the coming five years. But, as we know, things did not turn out quite like that.

3 What happened instead

- 3.1 Chapter 2 explained how the economy and the public finances evolved over the pre-crisis decade, and how they were expected to evolve over the subsequent five years in the March 2008 Budget. In this chapter we look at what happened instead.
- 3.2 We begin by summarising how the public finances evolved after 2007-08, relative to the Budget 2008 forecast, and how this reflected both developments in the economy and changes in tax and spending policy announced after Budget 2008. In Chapters 4 and 5, we look at the evolution of public sector revenues and spending in more detail.

The public finances

- 3.3 When Alistair Darling delivered what turned out to be the final pre-crisis Budget in March 2008, public sector net borrowing was expected to come in at £36 billion (2.6 per cent of GDP) and public sector net debt at £534 billion (37.1 per cent of GDP) in the 2007-08 fiscal year just ending. Mr Darling forecast that the deficit would widen a little to £43 billion (2.9 per cent of GDP) in 2008-09, but then narrow over the subsequent four years. He forecast that net debt would rise as a share of GDP until 2010-11 – peaking at just under 40 per cent – and then fall thereafter (although continuing to rise in cash terms).

Table 3.1: Net borrowing and net debt: Budget 2008 forecasts and outturns

	£ billion					
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Public sector net borrowing						
Budget 2008 forecasts	36.4	42.5	38.4	32.4	27.3	22.7
Outturns	38.0	99.4	157.3	139.2	118.0	115.1
<i>Differences from Budget 2008</i>	1.5	56.8	118.9	106.8	90.7	92.4
Public sector net debt						
Budget 2008 forecasts	534	581	627	666	700	731
Outturns	538	633	829	1,005	1,106	1,185
<i>Differences from Budget 2008</i>	3	52	202	339	406	454
	Per cent of GDP					
Public sector net borrowing						
Budget 2008 forecasts	2.6	2.9	2.5	2.0	1.6	1.3
Outturns	2.6	6.9	11.0	9.3	7.6	7.3
<i>Differences from Budget 2008</i>	0.0	4.0	8.5	7.3	6.0	6.1
Public sector net debt						
Budget 2008 forecasts	37.1	38.5	39.4	39.8	39.7	39.3
Outturns	36.8	44.6	56.4	65.9	71.2	74.2
<i>Differences from Budget 2008</i>	-0.3	6.1	17.0	26.1	31.5	34.9

What happened instead

3.4 As Table 3.1 summarises, the outcome was very different. Net borrowing ballooned to a post-war high of £157 billion (11.0 per cent of GDP) in 2009-10 and had only fallen to £115 billion (7.3 per cent of GDP) by 2012-13 – excluding transfers to the Exchequer related to the Royal Mail pension fund and quantitative easing.¹ This was far in excess of the £23 billion (1.3 per cent of GDP) deficit forecast in Budget 2008. Similarly, the outturn for net debt was far higher than expected. By 2012-13 it had reached £1,185 billion (74.2 per cent of GDP) rather than the £731 billion (39.3 per cent of GDP) forecast in Budget 2008 – and it was still rising as a share of GDP, let alone in cash terms.

Public sector net borrowing

3.5 Public sector net borrowing increased by almost £120 billion or 8½ per cent of GDP between 2007-08 and 2009-10, the sharpest two-year increase since World War II. Confronted by an unexpected fiscal deterioration on this scale, it is natural to ask whether this was primarily a ‘spending problem’ or a ‘receipts problem’. As Table 3.2 and Charts 3.1 and 3.2 illustrate, the answer appears to depend on whether you look at the behaviour of receipts and spending in cash terms or as percentages of GDP.

¹ Except where these transfers are specified, all outturn data in this paper are expressed on the basis of this underlying measure of PSNB that we have focused on in recent forecasts. From later this year, the ONS will implement its Review of the Public Sector Finances and methodological changes related to ESA10 National Accounts guidance. This will result in significant revisions to public finances data, particularly to the level of public sector net debt. For further details, see Annex B of our March 2014 *Economic and fiscal outlook* and relevant months of our commentaries on the monthly ONS/Treasury public finances releases.

Table 3.2: Budget 2008 public finance forecast errors

	£ billion					
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Public sector net borrowing	1.5	56.8	118.9	106.8	90.7	92.4
Receipts	-0.8	-38.9	-92.1	-91.9	-106.2	-134.1
<i>of which:</i>						
Income tax and NICs	-1.9	-18.5	-37.1	-48.7	-63.6	-81.9
Corporation tax	-0.1	-8.2	-19.7	-17.9	-21.3	-27.6
VAT	0.1	-8.9	-16.0	-7.4	0.1	-1.5
Stamp duty land tax	-0.2	-4.7	-6.2	-6.3	-7.2	-7.6
Spending	0.8	17.9	26.9	14.9	-15.5	-41.7
<i>of which:</i>						
Social security and tax credits	0.4	4.6	13.1	13.3	13.3	14.7
Debt interest	0.2	0.6	0.1	11.2	12.6	10.1
Other AME	2.5	16.1	5.3	-0.5	-5.9	-5.6
DEL	-2.4	-3.4	8.3	-9.1	-35.6	-60.8
	Per cent of GDP					
Public sector net borrowing	0.0	4.0	8.5	7.3	6.0	6.1
Receipts	-1.2	-1.9	-3.2	-2.7	-2.4	-2.5
<i>of which:</i>						
Income tax and NICs	-0.7	-0.9	-1.1	-1.7	-2.1	-2.3
Corporation tax	-0.1	-0.5	-1.1	-0.9	-1.0	-1.2
VAT	-0.2	-0.5	-0.6	0.0	0.6	0.8
Stamp duty land tax	0.0	-0.3	-0.4	-0.4	-0.4	-0.4
Spending	-1.2	2.1	5.3	4.6	3.5	3.6
<i>of which:</i>						
Social security and tax credits	-0.3	0.6	1.8	1.8	2.1	2.6
Debt interest	0.0	0.1	0.2	0.9	1.0	1.0
Other AME	0.1	1.2	0.7	0.3	0.1	0.3
DEL	-0.9	0.3	2.6	1.5	0.3	-0.2

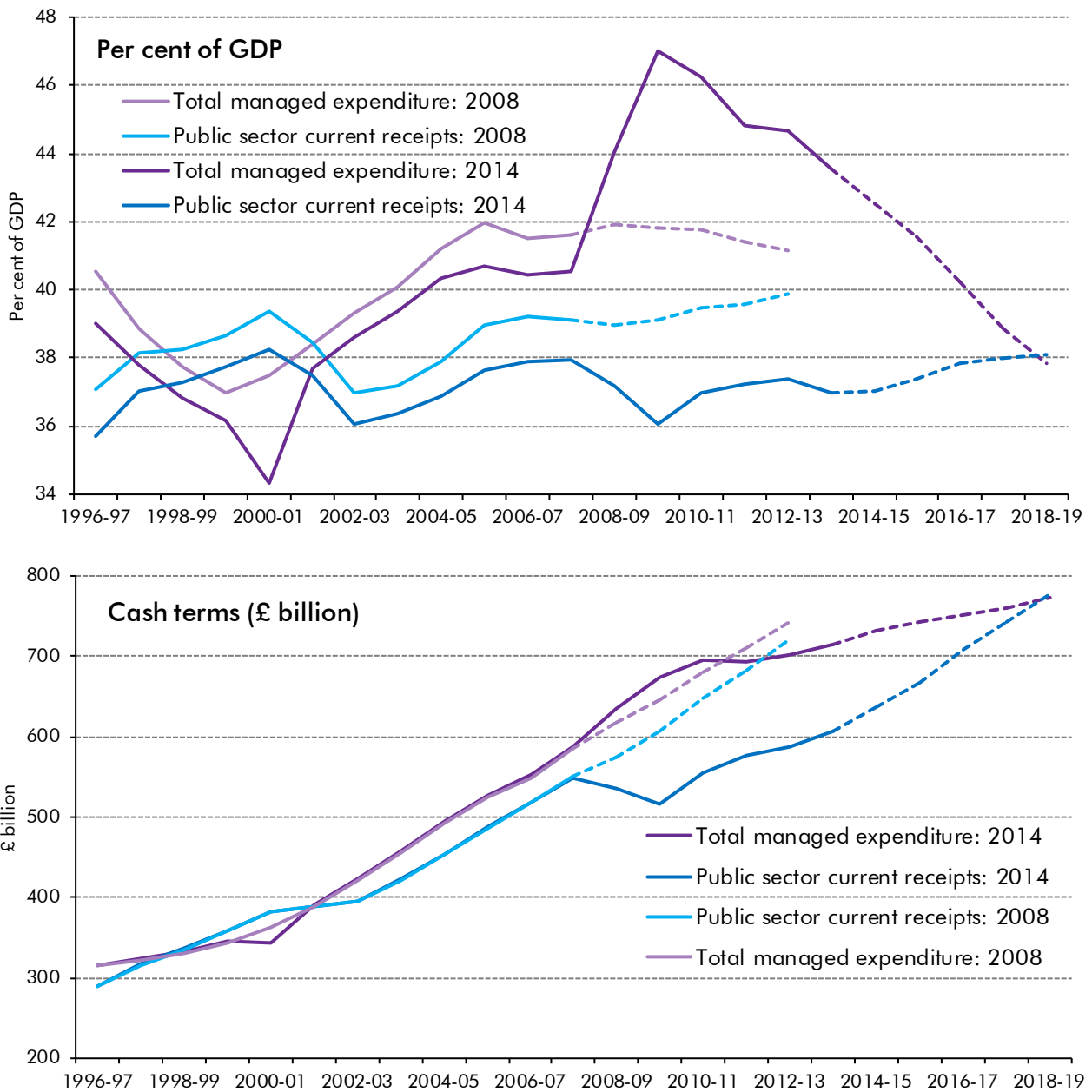
- 3.6 Viewed in cash terms, the main problem was that receipts fell sharply below their pre-crisis path over those two years. In contrast, spending growth increased only relatively modestly from its pre-crisis path. Budget 2008 underestimated net borrowing in 2009-10 by £118.9 billion, of which £92.1 billion (77 per cent) reflected a shortfall in receipts and only £26.9 billion (23 per cent) an overshoot in spending. The revenue shortfall was widely spread across the major taxes, while around half the spending overshoot was on social security and tax credits (with smaller contributions from departmental spending and other annually managed expenditure (AME)).
- 3.7 Viewed as shares of nominal GDP, however, the main problem was on the spending side. Having been broadly flat at around 40.5 per cent of GDP over the previous three years, total spending jumped by 6.5 per cent of GDP between 2007-08 and 2009-10 – a two-year increase only exceeded in the post-war period between 1972-73 and 1974-75. Meanwhile, receipts fell by just 1.9 per cent of GDP, a smaller drop than that seen between 2000-01 and 2002-03, following the bursting of the dot-com bubble.
- 3.8 So why a receipts problem in cash terms and a spending problems in shares of GDP? The main reason is that the recession saw the cash size of the economy (nominal GDP) fall in

What happened instead

absolute terms between 2007-08 and 2009-10, not just the volume of goods and services produced (real or inflation-adjusted GDP). This was in marked contrast to the recessions of the early 1980s and early 1990s, when real GDP fell but nominal GDP continued to rise. (The fall in nominal GDP was even larger, of course, relative to the Budget 2008 prediction that it would rise by around 10 per cent over those two years.)

- 3.9 Most receipts come from taxes levied on some portion of nominal GDP (e.g. labour income or consumer spending). So when nominal GDP fell short of expectations, so too did cash receipts – indeed proportionately more so. In 2009-10, nominal GDP undershot the Budget 2008 forecast by 6 per cent and cash receipts undershot it by 15 per cent. Public spending rose somewhat in cash terms as real and nominal GDP weakened, thanks primarily to higher welfare costs. The Government also modestly increased the multi-year cash plans it had set out for departmental spending on public services and capital. Total public spending and nominal GDP were both expected to rise by roughly 10 per cent in cash terms between 2007-08 and 2009-10, leaving spending unchanged as a share of GDP. But in the event cash spending rose by almost 15 per cent, while nominal GDP fell by 1.1 per cent. This increased total spending from 40.6 per cent of GDP to 47.0 per cent of GDP.

Chart 3.1: Public spending and receipts: Budget 2008 and Budget 2014



Source ONS, OBR. Excludes Royal Mail and APF transfers.

3.10 Between 2009-10 and 2013-14, the budget deficit shrank from £157 billion to £106 billion and from 11.0 per cent of GDP to 6.5 per cent of GDP – excluding transfers related to quantitative easing. As Charts 3.1 and 3.2 illustrate, receipts have started to rise again in cash terms, but not as quickly as they were rising prior to the crisis. Since 2010-11, spending has increased much more slowly than it did prior to the crisis in cash terms, and much more slowly than receipts. This is expected to continue until the gap between spending and receipts closes and the budget reaches balance in 2018-19 (see Chapter 6).

3.11 As a share of GDP, receipts (excluding transfers related to quantitative easing) remain almost 1 per cent of GDP below their pre-crisis level, but are forecast to rise by roughly that

What happened instead

amount over the next five years. Meanwhile spending has reversed slightly more than half of the increase recorded between 2007-08 and 2009-10 as a share of GDP and is expected to continue falling steadily over the next five years. This would be sufficient not only to reverse the full increase seen between 2007-08 and 2009-10, but also to eliminate the budget deficit that was being run prior to the crisis. (Chart 3.1 also illustrates that upward revisions to nominal GDP since 2008 have reduced the outturn estimates of spending and receipts during the pre-crisis decade as shares of GDP. The proceeds of the 3G spectrum auction in 2000-01 are also now treated as negative capital spending in that year rather than accrued as a stream of payments over 20 years, as they were in 2008.)

Public sector net debt

3.12 With the budget deficit running at far higher levels over the past six years than was expected prior to the crisis, the Government has accumulated much more debt than was forecast. Public sector net debt was expected to peak at just under 40 per cent of GDP in the Budget 2008 forecast – consistent with the sustainable investment rule in place at the time. Instead our March 2014 central forecast shows debt peaking at 78.7 per cent in 2015-16, around double the pre-crisis level. This would be the steepest rise in debt in the post-war period. In the early 1980s and early 1990s recessions, net debt rose by 2.3 and 15.9 per cent of GDP respectively between the pre-recession year and the subsequent peak. The rise between 2007-08 and 2015-16 is expected to be 41.9 per cent of GDP.

3.13 The rise in the ratio of net debt to GDP reflects both an unexpected increase in the cash value of the debt and (to a lesser extent) the denominator effect from unexpectedly low nominal GDP. Most of the rise in the cash value of the debt is explained by the large conventional budget deficits that have been run during and since the crisis, rather than by the direct costs of the financial interventions to bail out banks.

3.14 As Table 3.3 shows in more detail, the unexpectedly sharp rise in the cash level of net debt by 2012-13 reflected:

- the sharp rise in the budget deficit during the crisis. Cumulative net borrowing between 2007-08 and 2012-13 was £439 billion higher than expected in Budget 2008;
- borrowing from the private sector to finance financial transactions. The cumulative cash requirement for this purpose was £102 billion higher than expected by 2012-13. Much of this reflected interventions in the financial sector, for example issuing debt to finance the purchase of shares in Royal Bank of Scotland (RBS) and Lloyds Banking Group and lending money to Bradford and Bingley (B&B) to compensate depositors (on the assumption that this loan would eventually be repaid); and
- the reclassification of B&B and Northern Rock (Asset Management) (NRAM) as part of central government. Their liabilities are now included in net debt, but their assets (mostly their mortgage books) are not netted off because they are deemed illiquid.

3.15 These upward pressures on net debt were partially offset by:

- the classification of the bank shares purchased by the Government and the money lent for depositor compensation as liquid assets, which are subtracted from gross debt to get to net debt. This offsets much of the rise in net debt from financial transactions;²
- some gilts being issued at nominal values higher than their market value, reflecting the fact that gilt yields were at historic lows. (This reduced net debt by a cumulative £34 billion by 2012-13, as gilts are valued in net debt at their nominal value); and
- the transfers from the Bank of England's Asset Purchase Facility to the Exchequer in 2012-13, resulting from quantitative easing, and the cancellation of gilts that were held by the Royal Mail Pension Plan and transferred to the Government in April 2012.

Table 3.3: Explaining the error in the Budget 2008 public sector net debt forecast

	Per cent of GDP					
	Outturn					
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Budget 2008 - Forecast	37.1	38.5	39.4	39.8	39.7	39.3
Budget 2014 - Outturns	36.8	44.6	56.4	65.9	71.2	74.2
Change	-0.3	6.1	17.0	26.1	31.5	34.9
of which:						
Change in nominal GDP ¹	-0.6	2.5	3.3	3.9	5.2	6.4
Change in cash level of net debt	0.3	3.7	13.7	22.2	26.3	28.4
	£ billion					
Budget 2008 - Forecast	534	581	627	666	700	731
Budget 2014 - Outturns	538	633	829	1,005	1,106	1,185
Change in cash level of net debt	3	52	202	339	406	454
of which:						
Changes in net borrowing (ex. APF)	2	58	177	284	375	439
Financial transactions	-7	61	99	91	81	102
Bradford & Bingley and Northern Rock	0	0	45	56	42	34
Liquid assets from financial interventions	0	-67	-87	-61	-59	-58
Gilt premia	0	-3	-6	-11	-23	-34
Asset purchase facility	0	0	0	0	0	-11
RM gilts cancellation						-14
Other	9	3	-27	-19	-10	-4

¹ Non-seasonally-adjusted GDP centred end-March.

The economy

3.16 The public finances are affected by a wide range of observable economic determinants, mostly via their impact on particular flows of revenue and spending. These determinants drive the observable outturns for the public finances. But, as we have seen, policymakers are also interested in the underlying structural health of the public finances – how they would look if economic activity was running at a sustainable level. Assessing this depends

² As a result of the ONS's Review of the public finance statistics, the definition of liquid assets is being changed to exclude the purchase of shares and depositor compensation from the financial sector interventions. This will be incorporated in ONS releases from September 2014.

What happened instead

crucially on estimates of the unobservable 'potential' level of GDP consistent with maintaining stable inflation.³

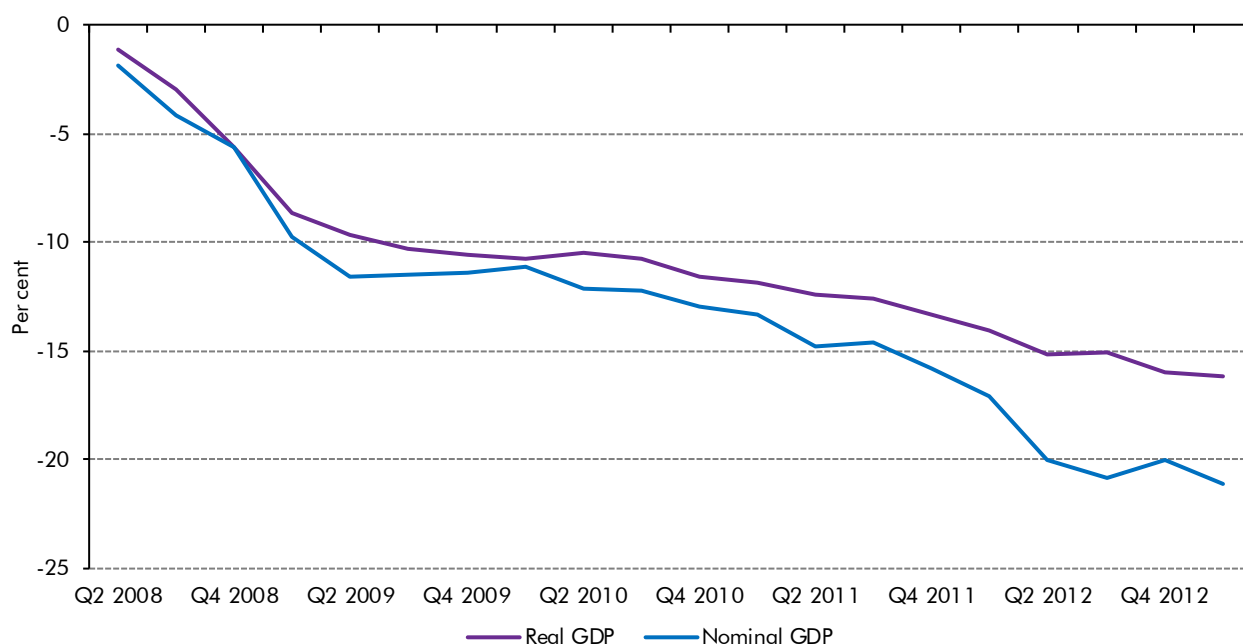
- 3.17 In the next three sections, we look in turn at: how the economy performed relative to the Budget 2008 forecast; what that meant for the key economic determinants of the public finances; and how estimates of potential GDP evolved – and what that implies for the size of the estimated structural budget deficit that requires policy measures to close.

Economic performance relative to the Budget 2008 forecast

- 3.18 The scale of the recession precipitated by the global financial crisis was entirely unforeseen in the Budget 2008 forecast. Instead of growing by 1.8 per cent in 2008 and 2.3 per cent in 2009, the latest data show that real GDP fell by 0.8 per cent and 5.2 per cent respectively. Indeed, by the end of 2009 the economy was already around 10 per cent smaller in real terms than had been predicted less than two years before. Thanks to the weakness of the subsequent recovery, this shortfall increased further over time. By the end of the Budget 2008 forecast period, in early 2013, real GDP was more than 16 per cent below forecast. As Chart 3.2 illustrates, the shortfall in nominal GDP – the key driver of the fiscal forecast – was even larger at 21 per cent by the end of the forecast period. This is because whole economy inflation was weaker than forecast, as well as real GDP.
- 3.19 As with all of this analysis in this paper, Chart 3.2 is presented on the basis of the current vintage of ONS data, compiled on the ESA95 National Accounts methodology that was also current at the of the Budget 2008 forecast. The ONS is implementing major revisions to the National Accounts this year in the process of moving to the new ESA10 methodology. Box 3.1 looks at how forthcoming revisions to ONS data might affect the shortfalls in Chart 3.2. While significant in absolute terms, those revisions are small relative to the very large differences between the Budget 2008 forecast and how the economy actually evolved.

³ See *Working Paper No.5 – Output gap measurement: judgement and uncertainty* for a discussion of the challenges posed by estimating this unobservable determinant of the structural fiscal position.

Chart 3.2: Cumulative errors in Budget 2008 forecast of real and nominal GDP



Source ONS, OBR

Real GDP

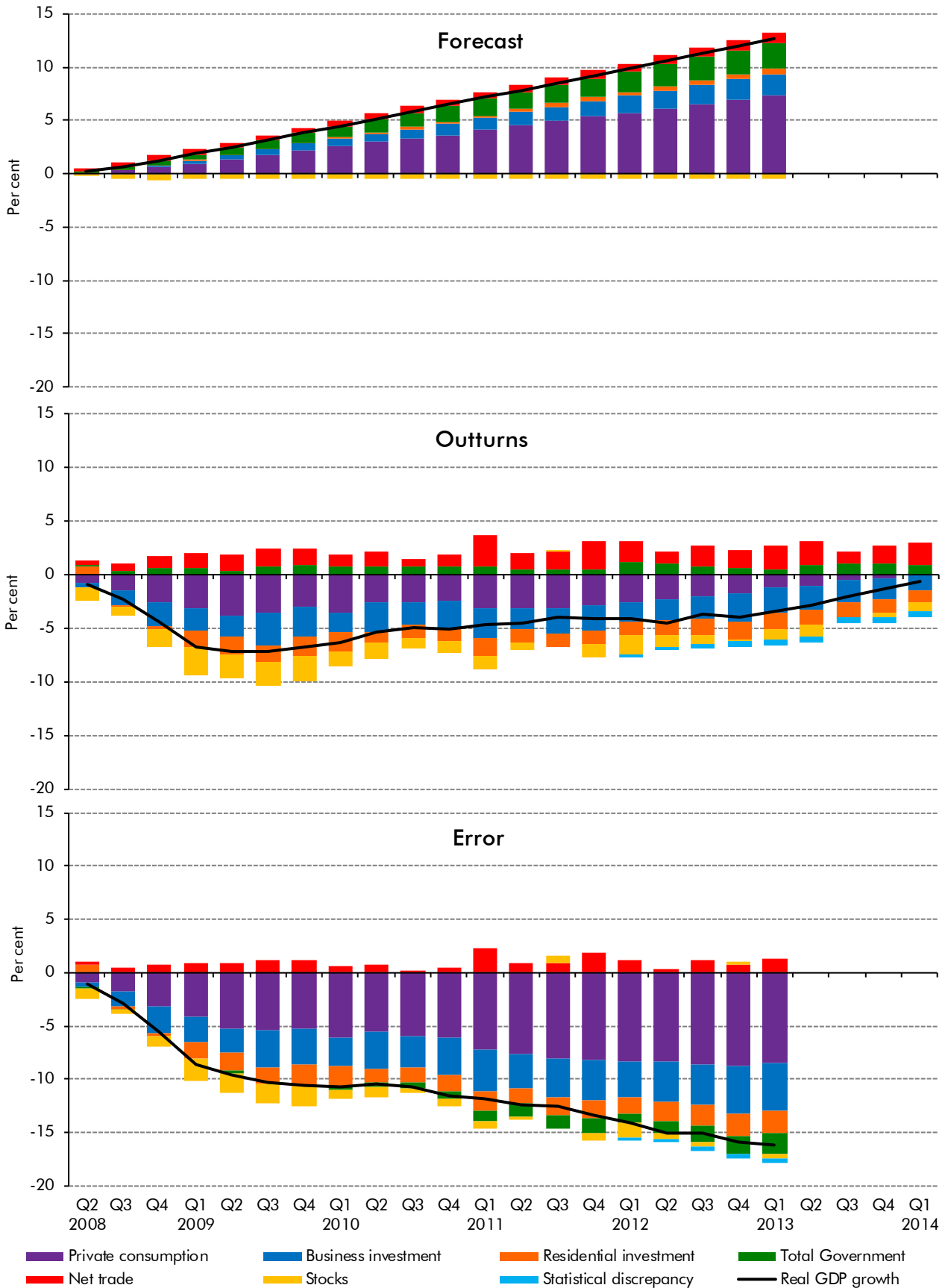
3.20 Table 3.4 compares the Budget 2008 forecast for real GDP and its expenditure components with the latest estimated outturns and then quantifies the errors in the forecast. (Chart 3.3 illustrates how those errors evolve across the forecast period.) Together, they show that the errors are fairly broadly based, with their composition evolving over time. By the end of the forecast period, the two biggest sources of the real GDP shortfall are private consumption and private investment (both business and residential).

Table 3.4: Contributions to real GDP growth from 2008Q1 to 2013Q1

	Percentage points							
	Private consumption	Business investment	Residential investment	Total Government	Net trade	Stocks	GDP	Statistical discrepancy
March 2008 forecast	7.3	2.1	0.5	2.4	0.9	-0.5	12.7	0.0
Latest data	-1.3	-2.4	-1.5	0.4	2.2	-0.9	-3.5	-0.5
Difference ¹	-8.6	-4.4	-2.0	-2.0	1.3	-0.4	-16.2	-0.5

¹ Difference in unrounded numbers.

Chart 3.3: Cumulative contributions to real GDP growth: expenditure



Source: ONS, OBR

- 3.21 Private consumption is the largest component of GDP and so, unsurprisingly, it was the largest contributor to the shortfall – even though consumption held up a little better than the rest of the economy. The consumption shortfall reflected weakness in wages and salaries, plus a sharp rise in the saving ratio as the crisis hit and confidence and credit evaporated. Budget 2008 forecast that the saving ratio would rise slowly from 3 per cent when the forecast was made to 4 per cent by 2012, but it had already reached more than 7 per cent by 2009.⁴ It is interesting to compare the shortfall in real consumption with that in nominal consumption (described below). In nominal terms, the shortfall flattened out over 2009 and 2010, but in real terms it continued to widen as higher than expected inflation squeezed the contribution to real GDP from a given amount of nominal consumption.
- 3.22 Private investment was the next largest source of the GDP shortfall, contributing only slightly less to the overall shortfall than private consumption – even though it is a much smaller component of GDP. Investment is normally subject to greater cyclical swings than consumption, but it was unusually hard-hit in this crisis by the impact of financial conditions on confidence and credit availability. Business investment is estimated to have fallen by 15 per cent in 2009 and residential investment by 28 per cent.
- 3.23 Government consumption and investment combined contributed about a quarter as much to the real GDP shortfall as either private consumption or private investment. Indeed it was moving broadly in line with the Budget 2008 forecast until 2009, but then started to fall short of the forecast from 2010 as the fiscal consolidation got underway.
- 3.24 Net trade was the only category of spending that contributed more positively to GDP than forecast in Budget 2008. But this should be seen in the context of the 30 per cent peak-to-trough depreciation of sterling and the collapse in imports during the crisis. Given these developments, it is probably surprising that net trade did not outperform by a greater margin. That it failed to do so is likely to reflect a combination of weakness in the UK's export markets, particularly the euro area, and the limited extent to which sterling's depreciation fed through to improvements in market share, perhaps because the lack of credit and confidence impeded the flow of resources to exploit export opportunities.

Nominal GDP

- 3.25 Nominal GDP had fallen 21 per cent below the Budget 2008 forecast by the start of 2013, a shortfall equivalent to around £390 billion in annualised terms by that point.⁵ In expenditure terms (Table 3.5 and Chart 3.4), private consumption and private investment contributed most to the shortfall, as with real GDP. Government consumption acted as a drag from 2010 onwards as the fiscal consolidation kicked in. In income terms (Table 3.6 and Chart 3.5), the largest contributions to the shortfall were compensation of employees and profits, with both contributing roughly equivalent amounts, broadly matching the pattern of nominal consumption and investment. Much of the error forecasting

⁴ Note that later this year the ONS will update the National Accounts to reflect ESA10 – the new European System of Accounts – which is expected to lead to a large upward revision to the level of the saving ratio in all years.

⁵ This is relative to nominal GDP as measured at the time of Budget 2008. There have been a number of methodological changes to the measurement of nominal GDP since then that have raised its level, meaning the difference between the Budget 2008 forecast and the latest estimate is smaller. This year's switch to ESA10 will see the level of nominal GDP revised up further.

What happened instead

compensation of employees reflects weaker wages than expected, mirroring the unexpected weakness of productivity.

Table 3.5: Expenditure contributions to nominal GDP growth from 2008Q1 to 2013Q1

	Percentage points						GDP	Statistical discrepancy
	Private consumption	Private investment	Total Government	Net trade	Stocks			
March 2008 forecast	17.4	5.6	5.9	0.2	-0.5	28.7	0.0	
Latest data	8.4	-3.0	1.9	1.1	-0.3	7.5	-0.6	
Difference ¹	-9.0	-8.6	-4.0	0.9	0.2	-21.1	-0.6	

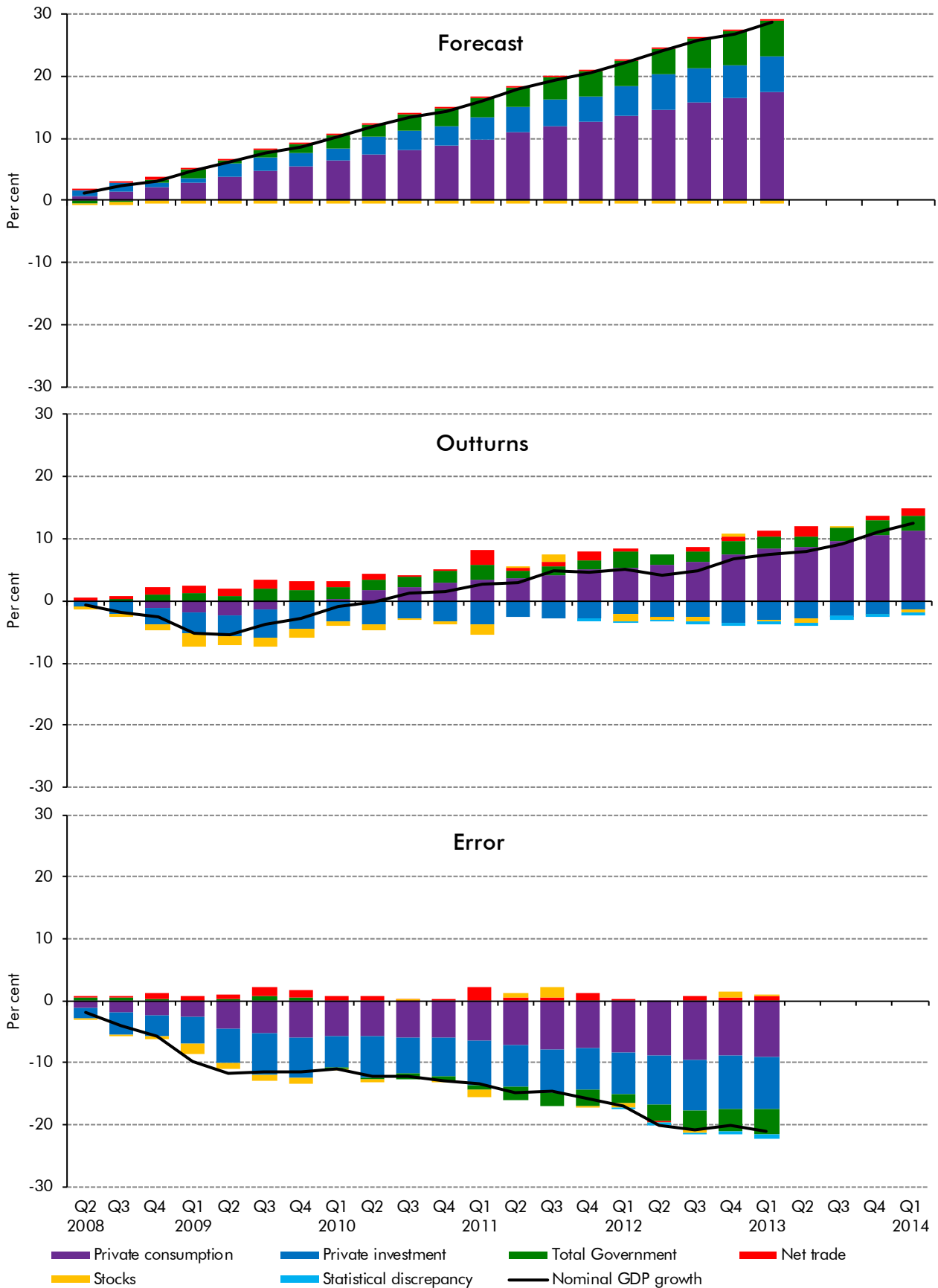
¹ Difference in unrounded numbers.

Table 3.6: Income contributions to nominal GDP growth from 2008Q1 to 2013Q1

	Percentage points				GDP	Statistical discrepancy
	Compensation of employees	Corporations' gross operating surplus	Other income	Taxes on products and production		
March 2008 forecast	15.9	5.7	4.0	3.1	28.7	0.0
Latest data	4.7	-1.4	1.8	2.3	7.5	0.1
Difference ¹	-11.2	-7.0	-2.2	-0.7	-21.1	0.1

¹ Difference in unrounded numbers.

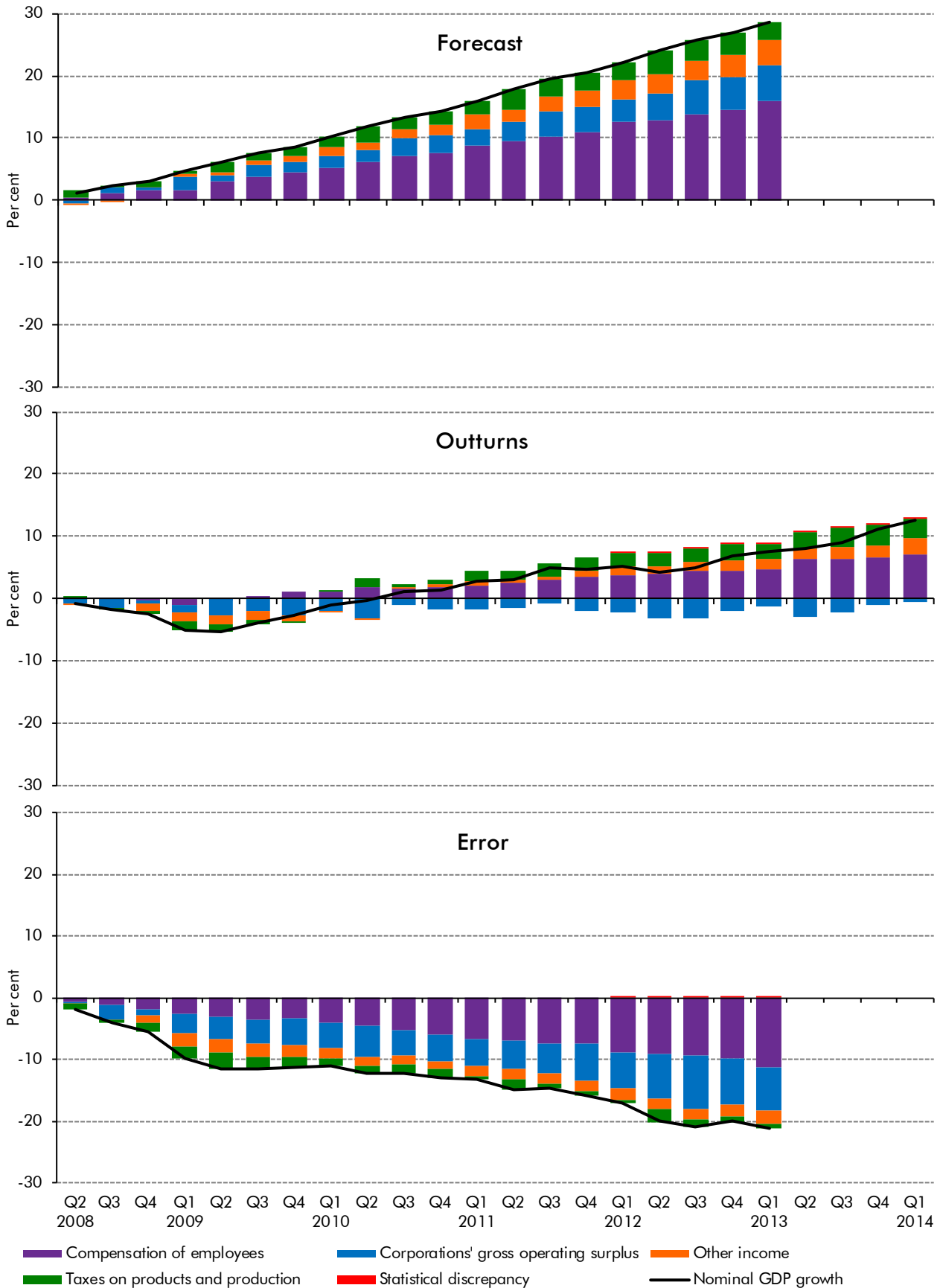
Chart 3.4: Cumulative contributions to nominal GDP growth: expenditure



Source: ONS, OBR

What happened instead

Chart 3.5: Cumulative contributions to nominal GDP growth: income



Source: ONS, OBR

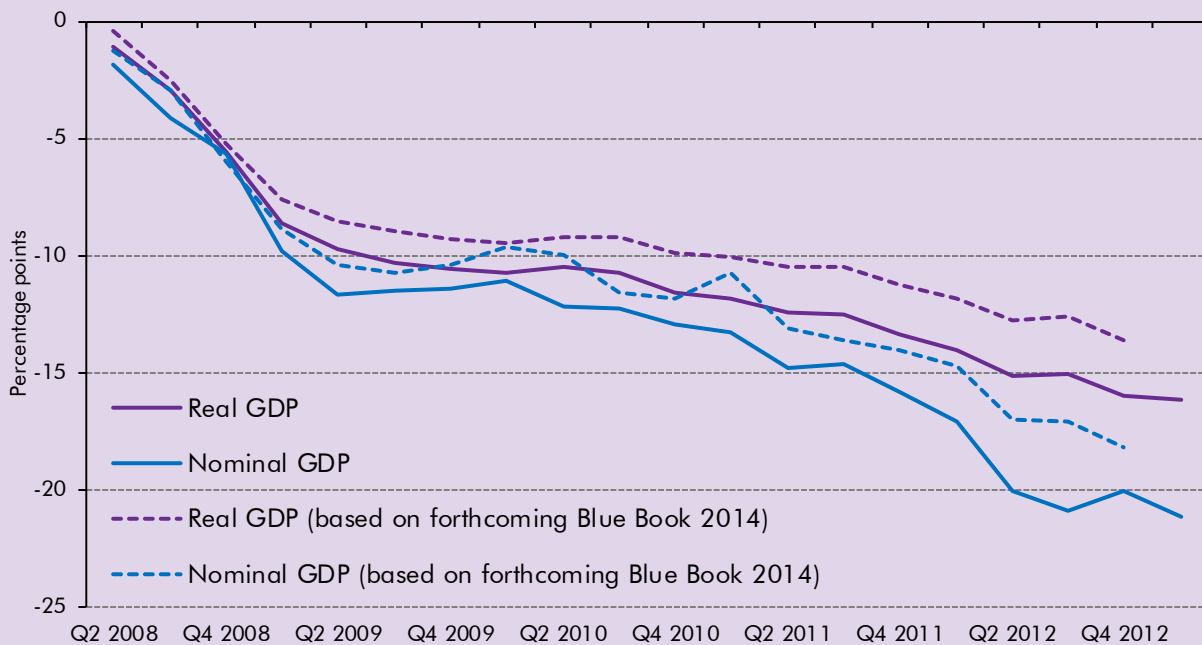
Box 3.1: Forthcoming revisions to GDP data

Estimates of GDP are revised over time as new information becomes available and as methodologies are updated. This rewriting of economic history can mean that economic circumstances appear very different in hindsight than they do in real-time. We have looked at the effects of these revisions on our understanding the 1990s recession (in the 2013 *Forecast evaluation report*) and on estimates of the output gap (in *Working paper No.5*).

On 3 September, the ONS published near-final illustrative estimates of real and nominal GDP growth up to the end of 2012, using the methodologies that will be applied from this year’s Blue Book, which will be published on 30 September. In a pattern familiar from the mid-1990s, the prospective revisions deliver a significant rewriting of recent economic history. The peak-to-trough fall in real GDP through the recent recession is now estimated at 6.0 per cent rather than the 7.2 per cent in the data vintage used in this paper. And cumulative growth since the trough in GDP in mid-2009 to the end of 2012 has been revised up from 3.4 per cent to 4.7 per cent.

While these revisions are material, as Chart A shows, relative to the enormous shortfall in GDP relative to the Budget 2008 forecast, they are certainly not large enough to change the basic story that is set out in the paper. By the end of 2012, the shortfall in real GDP would be 13½ per cent rather than 16 per cent and the shortfall in nominal GDP would be 18 per cent rather than 20 per cent. But it is important to remember that these outturn data will be on a different methodological basis to the outturns that the Government was trying to forecast in 2008.

Chart A: Cumulative errors in the Budget 2008 GDP forecast on a Blue Book 2014 basis

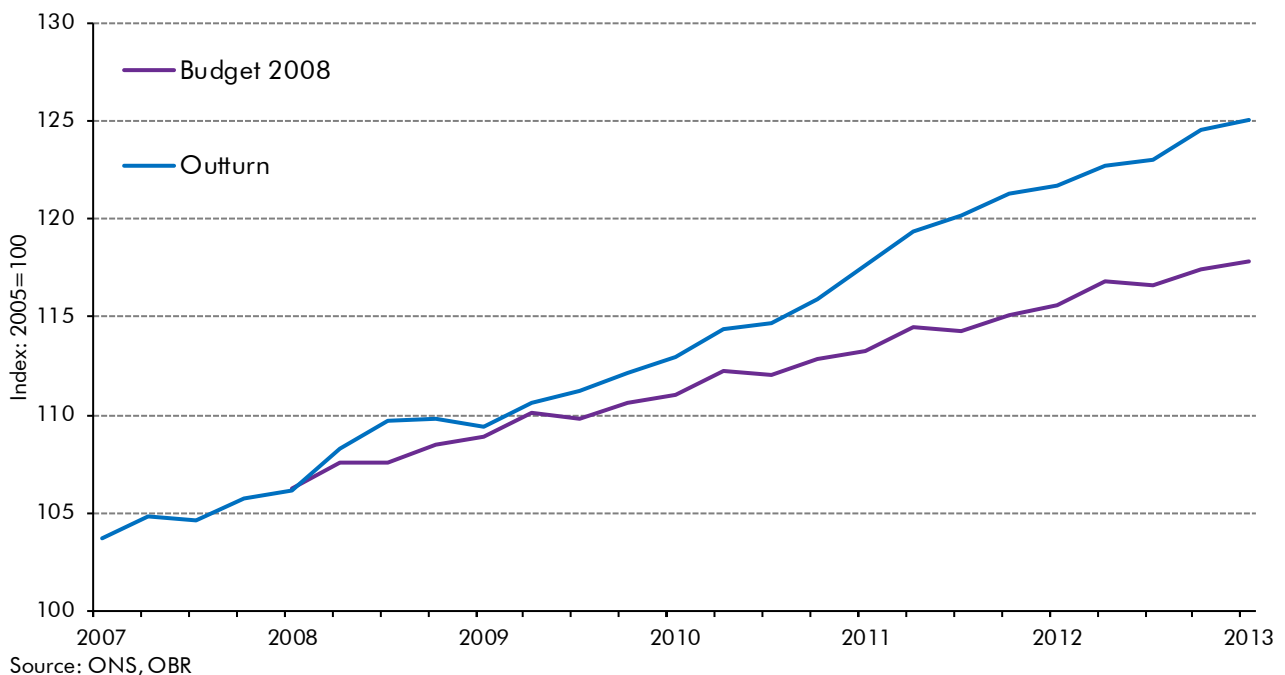


Source: ONS, OBR

Inflation

- 3.26 CPI inflation remained consistently higher than the Budget 2008 forecast, even though that forecast had not anticipated that there would be a recession. Over the forecast as a whole, consumer prices rose by a cumulative 18 per cent compared to the forecast of 11 per cent. CPI inflation was pushed higher by the weak exchange rate (which increased import prices from 2008 onwards) and by higher oil prices in the last two years of the forecast. Relative to CPI inflation, retail price (RPI) inflation was reduced by the fall in mortgage interest payments, as Bank Rate was cut sharply. But it still remained higher on average than the Budget 2008 forecast – pushing up payments to holders of index-linked gilts.
- 3.27 By contrast with the measures of inflation assumed to affect households, the GDP deflator – the broadest measure of whole economy inflation for domestically produced goods and services – actually increased by less than forecast, contributing to the nominal GDP shortfall. The divergence in forecast errors between CPI inflation and the GDP deflator largely reflected higher than expected import prices, which push up consumer prices but have less effect on the price of domestic production.

Chart 3.6: Consumer Prices Index: Budget 2008 forecast and outturns



The labour market

- 3.28 One of the most striking features of the UK economy since the crisis has been the resilience of the labour market in the face of exceptional weakness in output. Employment was around 400,000 lower than forecast by the start of 2013, but that represents a shortfall of just 1½

per cent compared to the shortfall of 16 per cent for real GDP. The difference highlights the ‘productivity puzzle’ that has been a key source of uncertainty and forecast error.⁶

Table 3.7: Changes in labour market indicators between 2008Q1 and 2013Q1

	Thousands					
	Market sector employment	General Government employment	Total employment	Unemployment (LFS)	Claimant count	Activity
March 2008 forecast ¹	612	2	614	106	54	720
Latest data ¹	402	-204	198	900	754	1098
Difference ²	-210	-206	-416	794	701	378

¹Outturns and the March 2008 forecast have been adjusted, so that employment in English colleges is outside of the general government sector (and therefore in the market sector) in all periods.

² Difference in unrounded numbers, rounded to nearest thousand.

3.29 During the crisis, market sector employment fell by 0.8 million between the start of 2008 and the start of 2010. Over the subsequent three years it rose by 1.2 million. In contrast, general government employment rose slightly during the recession, but then fell by 360,000 from its peak between the end of 2009 and the start of 2013, reflecting the fiscal consolidation. Over the whole period to the end of 2012-13, market sector employment rose by around 400,000 (rather than the 600,000 forecast prior to the crisis) while general government employment fell by around 200,000 (rather than remaining flat).

3.30 The resilience of employment in the latest recession is partly explained by the weakness of earnings growth, which has mirrored the weakness of productivity. Total wages and salaries grew by 8 per cent between 2007-08 and 2012-13, much weaker than the 29 per cent forecast at Budget 2008. Since employment held up, this was due primarily to weak earnings growth. Average earnings rose by just 8 per cent between 2007-08 and 2012-13, compared to the Budget 2008 forecast of 26 per cent. Wages and salaries are the main tax base for PAYE income tax and National Insurance Contributions (NICs), which together account for around 40 per cent of total receipts. Chapter 4 argues that weak growth in wages and salaries was the biggest contributor to the receipts forecast error at Budget 2008. But the combination of relatively resilient employment and relatively weak average earnings also lowered the average tax rate on income, because a greater proportion of total wages and salaries are subject to the tax-free personal allowance.

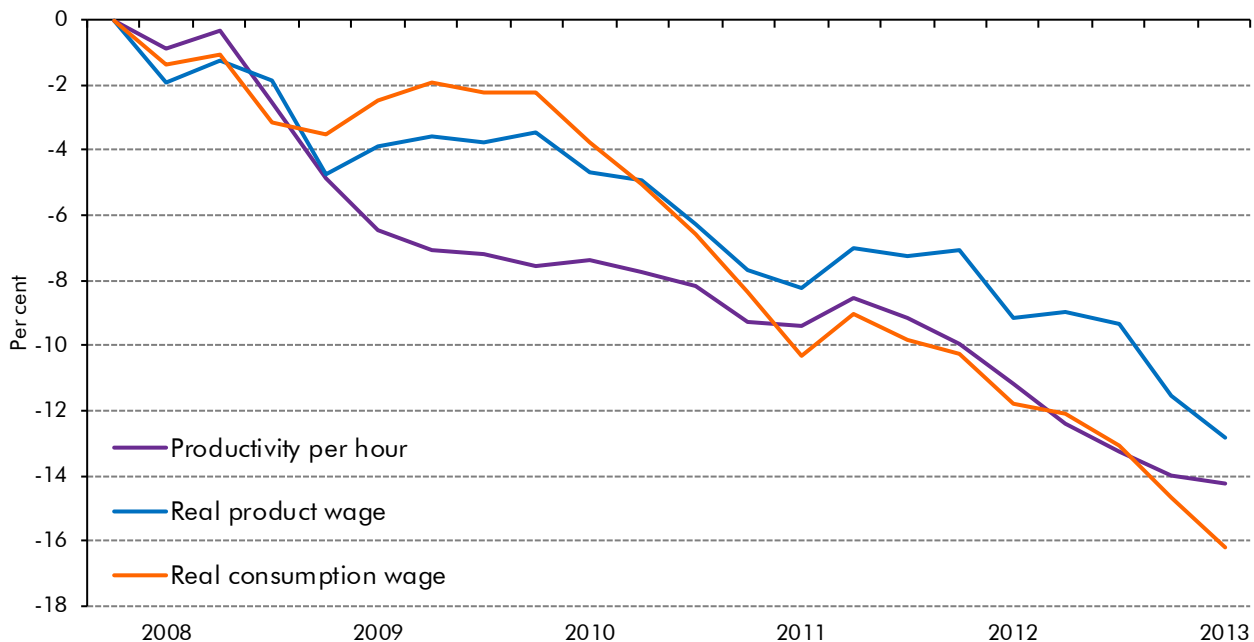
3.31 The weakness of wages relative to inflation also bears down on the average tax rate – when wages rise more slowly than inflation, the uprating of tax thresholds means that less income is subject to higher tax rates. This is the reverse of the normal process of ‘fiscal drag’. The weakness in real wages over the Budget 2008 forecast period broadly matches the weakness of productivity. Chart 3.8 compares forecast errors for two measures of real hourly earnings with the error for productivity per hour. The ‘real product wage’ is what matters to employers – it measures the level of wages relative to the price of the output they sell. The ‘real consumption wage’ is what matters to consumers – it measures wages relative to the price of the things they consume. During the recession, the shortfall in productivity

⁶ For a recent overview of the productivity puzzle and some of the possible explanations of its size and persistence, see Bank of England (2014).

What happened instead

relative to forecast was greater than the shortfall in both measures of real wages, with profit margins also squeezed. By the start of 2013, the real consumption wage had fallen further below forecast than productivity, as higher VAT and import prices raised the cost of living.

Chart 3.7: Cumulative productivity and real wage forecast errors relative to the March 2008 forecast



Source: ONS, OBR

3.32 Although unemployment rose by less in this recession than in previous recessions, it was still significantly higher than forecast. On the claimant count measure, which is linked most directly to the public finances, it was around 700,000 above forecast by the start of 2013. Interestingly, the error on unemployment was larger than that on employment, because the number of people actively participating in the labour market was higher than forecast (in marked contrast to the experience of the United States over the same period). This could reflect a number of factors, including the rise in activity among older people during and since the recession and the population growing more rapidly than expected.⁷

The economic determinants of the fiscal forecast

3.33 Table 2.1 recreated for the Budget 2008 forecast the economic determinants table that we publish in our *EFOs*. This table brings together all the economic variables that have a significant impact on the fiscal forecasts, the forecasts for many of which in Budget 2008 were not actually published at the time. Table 3.8 below shows the outturns for those same determinants and Table 3.9 reports the implied forecast errors.

3.34 As set out above, the key economic developments relevant to the fiscal forecast were that:

- real GDP dropped sharply and then recovered very slowly;

⁷ See Annex A to the 2014 *Fiscal sustainability report* for a discussion of recent labour market trends and their fiscal implications.

- nominal GDP fell slightly and then recovered very slowly;
- CPI and RPI inflation were higher than expected in Budget 2008, notwithstanding the recession, but GDP deflator growth was lower than forecast; and
- employment was much more resilient than we would have expected given the path of real GDP, while productivity and earnings growth were weaker.

3.35 Also important was the performance of **housing and equity markets**, which was also well below Budget 2008 expectations. By 2012-13, equity prices were 18 per cent below forecast and house prices 19 per cent below. Property transactions were more than 50 per cent below forecast, which was particularly costly because stamp duty land tax is only paid when a transaction takes place. Asset prices and turnover also affect receipts from capital gains tax, inheritance tax and stamp duty on shares, so this weakness in asset markets played a significant role in the deterioration of the public finances.

3.36 The receipts-rich **financial sector** was also hit disproportionately hard. Financial company profits were significantly lower than forecast, reducing revenue from corporation tax. Large losses made by financial companies during and after the crisis were also a major reason for the receipts shortfall, since they can be carried forward and used to offset future tax liabilities. As it will take some years before these losses have been used up, this is expected to impede the pick-up in corporation tax receipts for some time. Wages and bonuses paid by financial companies were also a major source of income tax receipts, but were hit hard by the crisis. Tax from bonuses was estimated to have fallen by nearly a half on a year earlier in 2008-09.

3.37 Finally, **interest rates** fell sharply relative to the Budget 2008 forecast, reflecting monetary policy decisions for short-term interest rates and broader financial market developments for longer-term government bond yields. This partially offset the impact of higher borrowing on debt interest costs. But the effect of lower interest rates is not uniformly positive for the public finances. Lower rates also reduce tax on savings income and interest and dividend receipts on the Government's stock of financial assets.

Table 3.8: Economic determinants for the Budget 2008 fiscal forecast: outturns

	Percentage change on previous year unless otherwise specified						
	Outturn						
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	07-08 to 12-13
GDP and its components							
Real GDP	3.5	-3.2	-3.4	2.0	0.8	0.3	-3.5
Nominal GDP ¹	5.7	-0.4	-0.7	4.9	3.0	1.2	8.1
Nominal GDP (£ billion) ^{1,2}	1,448	1,442	1,432	1,502	1,547	1,566	118
Nominal GDP (centred end-March £bn) ^{1,3}	1,463	1,420	1,469	1,526	1,553	1,598	135
Wages and salaries ⁴	5.4	0.7	0.8	1.6	2.3	2.6	8.1
Non-oil PNFC profits ^{4,5}	4.4	-0.7	-10.1	4.0	5.9	4.0	2.3
Consumer spending ^{4,5}	5.4	2.2	-1.8	5.1	3.5	3.3	12.8
Prices and earnings							
GDP deflator	2.5	2.8	2.8	2.6	2.3	1.1	12.0
RPI (September)	3.9	5.0	-1.4	4.6	5.6	2.6	17.3
CPI (September)	1.8	5.2	1.1	3.1	5.2	2.2	17.9
Average earnings ⁶	4.5	0.6	3.0	1.0	2.5	1.2	8.5
Key fiscal determinants							
Claimant count (millions)	0.8	1.1	1.6	1.5	1.6	1.6	0.7
Employment (millions)	29.3	29.4	28.9	29.1	29.2	29.6	0.3
VAT gap (per cent)	11.7	14.2	11.6	10.4	10.4	10.9	-0.8
Output gap (per cent of potential output)	2.2	-1.2	-3.9	-2.6	-2.9	-2.8	-5.0
Financial and property sectors							
Equity prices (FTSE All-Share index)	3,234	2,383	2,619	2,885	2,903	3,066	-168
HMRC financial sector profits ^{1,5,7}	-1.0	-3.5	10.5	3.1	-5.7	3.4	7.2
Residential property prices ⁸	9.9	-5.8	-2.9	5.3	-0.9	2.1	-2.5
Residential property transactions (000s) ⁹	1,474	793	893	876	917	930	-544
Commercial property prices ⁹	-18.2	-27.3	5.9	2.4	4.4	2.3	-15.8
Commercial property transactions ⁹	3.9	-21.0	-17.5	8.7	-2.8	1.5	-30.1
Oil and gas							
Oil prices (\$ per barrel) ⁵	72.7	97.7	61.9	79.6	111.0	112.0	39.2
Oil prices (£ per barrel) ⁵	36.3	52.7	39.5	51.5	69.2	70.6	34.3
Gas prices (p/therm) ⁵	30.4	62.9	33.1	41.2	58.9	61.4	31.1
Oil production (million tonnes) ^{5,10}	76.8	71.3	67.8	63.0	51.9	44.5	-32.3
Gas production (billion therms) ^{5,10}	26.4	25.5	21.6	20.6	16.1	13.8	-12.6
Interest rates and exchange rates							
Market short-term interest rates (%) ¹¹	6.0	4.6	0.8	0.7	1.0	0.7	-5.3
Market gilt rates (%) ¹²	4.8	3.8	3.2	2.8	2.2	1.6	-3.1
Euro/Sterling exchange rate (€/£)	1.4	1.2	1.1	1.2	1.2	1.2	-0.2

¹ Not seasonally adjusted.

² Denominator for receipts, spending and deficit forecasts as a per cent of GDP.

³ Denominator for net debt as a per cent of GDP.

⁴ Nominal.

⁵ Calendar year.

⁶ Wages and salaries divided by employees.

⁷ HMRC Gross Case 1 trading profits.

⁸ Outturn data from ONS House Price Index

⁹ Outturn data from HMRC information on stamp duty land tax.

¹⁰ Department of Energy and Climate Change (DECC) forecasts available at www.gov.uk/oil-and-gas-uk-field-data

¹¹ 3-month sterling interbank rate (LIBOR).

¹² Weighted average interest rate on conventional gilts.

Table 3.9: Economic determinants for the Budget 2008 forecast: errors

	Percentage change on previous year unless otherwise specified						
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	07-08 to 12-13
GDP and its components							
Real GDP	0.6	-4.8	-5.9	-0.6	-1.7	-2.3	-15.9
Nominal GDP ¹	-0.4	-5.2	-5.9	-0.4	-2.3	-4.1	-20.7
Nominal GDP (£ billion) ^{1,2}	42	-31	-118	-130	-172	-245	-288
Nominal GDP (centred end-March £bn) ^{1,3}	23	-91	-122	-150	-212	-261	-284
Wages and salaries ⁴	1.2	-4.0	-4.3	-4.1	-3.1	-2.6	-20.7
Non-oil PNFC profits ^{4,5}	-7.2	-6.3	-15.2	-1.2	0.6	-1.3	-27.3
Consumer spending ^{4,5}	-0.4	-2.5	-6.7	0.0	-1.6	-1.8	-14.8
Prices and earnings							
GDP deflator	-0.7	-0.3	0.1	0.0	-0.4	-1.6	-2.6
RPI (September)	0.0	1.6	-3.6	1.5	2.7	-0.2	2.0
CPI (September)	0.0	2.3	-1.0	1.1	3.2	0.2	6.4
Average earnings ⁶	1.1	-3.4	-1.8	-4.1	-2.4	-3.5	-17.2
Key fiscal determinants							
Claimant count (millions)	0.0	0.2	0.7	0.6	0.7	0.7	0.7
Employment (millions)	0.0	-0.1	-0.7	-0.6	-0.7	-0.4	-0.4
VAT gap (per cent)	-3.2	-1.0	-4.0	-5.7	-6.3	-6.3	-3.1
Output gap (per cent of potential output)	1.9	-0.7	-3.5	-2.3	-2.7	-2.8	-4.7
Financial and property sectors							
Equity prices (FTSE All-Share index)	-8	-659	-582	-485	-647	-673	-665
HMRC financial sector profits ^{1,5,7}	-5.0	-5.5	-6.5	-2.9	-16.7	-5.6	-45.9
Residential property prices ⁸	0.0	-6.8	-5.5	0.1	-5.7	-2.7	-22.2
Residential property transactions (000s) ⁹	-235	-766	-874	-962	-953	-961	-726
Commercial property prices ⁹	-3.2	-22.3	0.7	-2.8	1.7	-0.4	-26.7
Commercial property transactions ⁹	0.9	-21.0	-19.5	6.8	-4.6	-0.3	-37.8
Oil and gas							
Oil prices (\$ per barrel) ⁵	0.3	13.9	-23.1	-6.6	23.4	23.1	22.8
Oil prices (£ per barrel) ⁵	0.1	10.5	-3.8	6.7	23.0	23.0	22.9
Gas prices (p/therm) ⁵	-2.5	19.2	-8.9	-3.1	13.2	13.5	16.0
Oil production (million tonnes) ^{5,10}	0.0	-0.6	0.0	-1.5	-9.6	-13.8	-13.8
Gas production (billion therms) ^{5,10}	0.0	0.6	-2.1	-1.5	-4.0	-5.3	-5.3
Interest rates and exchange rates							
Market short-term interest rates (%) ¹¹	0.0	-0.5	-3.6	-4.2	-4.1	-4.4	-4.5
Market gilt rates (%) ¹²	0.0	-1.1	-1.6	-2.1	-2.8	-3.4	-3.4
Euro/Sterling exchange rate (€/£)	0.0	-0.1	-0.1	-0.1	-0.1	0.0	0.0

¹ Not seasonally adjusted.² Denominator for receipts, spending and deficit forecasts as a per cent of GDP.³ Denominator for net debt as a per cent of GDP.⁴ Nominal.⁵ Calendar year.⁶ Wages and salaries divided by employees.⁷ HMRC Gross Case 1 trading profits.⁸ Outturn data from ONS House Price Index⁹ Outturn data from HMRC information on stamp duty land tax.¹⁰ Department of Energy and Climate Change (DECC) forecasts available at www.gov.uk/oil-and-gas-uk-field-data¹¹ 3-month sterling interbank rate (LIBOR).¹² Weighted average interest rate on conventional gilts.

Box 3.2: The economic determinants: comparing recent recessions

In a number of respects, the main economic determinants of the fiscal forecast behaved very differently in the latest recession than in those of the early 1980s and early 1990s (Chart A). This helps to explain why the consequences for the public finances have been more severe.

The peak-to-trough fall in real GDP between the first quarter of 2008 and the second quarter of 2009 is currently estimated at 7.2 per cent. This compares with a 5.9 per cent fall in the early 1980s and a 2.4 per cent fall in the early 1990s. More importantly, nominal GDP continued to rise in the earlier recessions, but in the latest it fell. This reflects the fact that the latest recession was triggered by a financial crisis at a time when consumer and whole economy inflation were relatively contained, rather than by the need to reduce unsustainably high rates of inflation that then persist for some time as output growth slows.

A similar pattern is evident in the tax bases that are components of nominal GDP: wages and salaries, nominal consumer spending and onshore company profits. In particular, growth in wages and salaries, the tax base for PAYE and NICs receipts, was much weaker than in previous recessions. While the fall in employment over the peak-to-trough period was marginally smaller than in the previous two recessions, earnings growth was much weaker. Higher nominal earnings growth in the early 1980s and early 1990s also reflected the higher inflation rates prior to those recessions. The unemployment rate, as measured by the claimant count, rose by around 2½ percentage points in the recent recession, compared to 6 percentage points in the 1980s recession. The weakness of labour income fed through to similar weakness in nominal consumer spending, the tax base for VAT receipts. Profits fell sharply in each of the past three recessions.

Equity and housing markets performed much worse in the recent recession. In particular, lack of credit led to a very steep fall in residential property transactions. From their pre-crisis peak in the first quarter of 2007, property transactions fell by over 60 per cent by the first quarter of 2009.

Chart B: Key fiscal determinants in the last three recessions



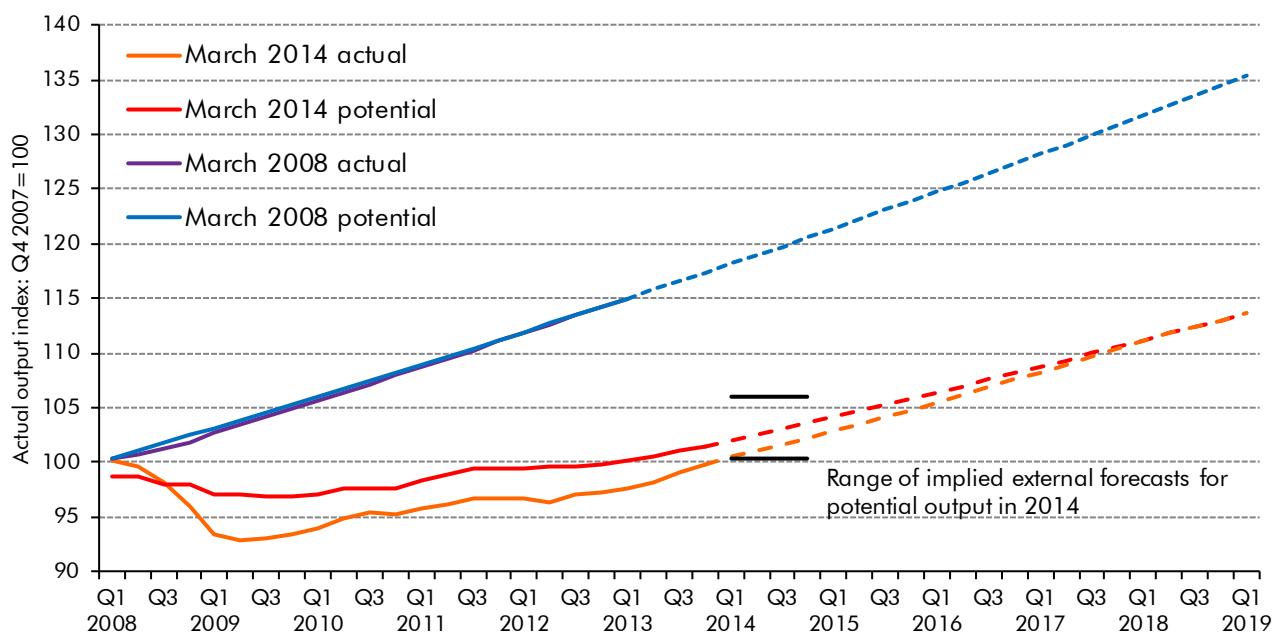
Source: ONS, OBR

Potential GDP and its implications for the structural budget deficit

Potential output

- 3.38 As we have seen, the budget deficit widened dramatically during the financial crisis and recession. A key question for policymakers – then and now – is by how much it can be expected to narrow automatically as the shortfall in GDP and the other determinants of the fiscal forecast reverses, and how much will remain to be dealt with by policy measures.
- 3.39 Central to answering this question is the need to estimate the economy's underlying potential – the level of output consistent with maintaining stable inflation. We would expect the economy to tend to this level of activity over time as the Bank of England sets monetary policy to achieve and maintain the inflation target it has been given. If potential output were to grow as projected in Budget 2008 – and the widening in the budget deficit relative to that forecast largely reflected the fact that actual output has temporarily fallen below this level (weakening tax receipts and pushing up welfare costs) – then most of the additional borrowing should disappear as economic activity recovers. But if potential output is lower than projected in Budget 2008 – either because it has been damaged by the crisis and recession or because the crisis and recession have exposed earlier over-optimism – then some of the deficit will remain after the economy returns to full potential and policy action will be needed to reduce it further. The part of the deficit that is expected to disappear as the economy recovers to potential is referred to as 'cyclical', while the part that is left is 'structural' or 'cyclically adjusted'.
- 3.40 At Budget 2008, the Treasury estimated that the economy was operating at around its potential level, as shown in Chart 3.8. The forecast was that the UK economy would experience a very brief slowdown and then return to trend. The output gap was forecast to widen to -0.6 per cent by the end of 2008, then to close slowly over the subsequent 3½ years. The level and growth rate of potential output were assumed not to be affected by output moving below trend. Our latest judgement, set out in our March 2014 *EFO*, is that there has been a large hit to the level of potential GDP, relative to the level projected in Budget 2008. Compared with an extension of the Budget 2008 forecast this amounts to around 12½ per cent in 2012-13 and 16 per cent by 2018-19, around £270 billion a year in today's terms. Most economic forecasters have reached a similar conclusion, with even the most optimistic assessments of potential GDP lying well below the Budget 2008 forecast.

Chart 3.8: Potential and actual output forecasts in 2008 and 2014



Source: HM Treasury, OBR

3.41 The revision to potential output shown in Chart 3.8 has been the result of downward revisions in successive official forecasts since Budget 2008. The most significant downward revisions came in:

- the November 2008 Pre-Budget Report, when the Treasury argued that “to take account of the likely negative effect of the credit shock on trend output, a phased reduction to the trend level of productivity (and therefore the trend level of output) of about 4 per cent has been assumed over the two years from mid-2007”;⁸
- the June 2010 Pre-Budget forecast published by the interim OBR, which argued that there was less spare capacity than the Treasury had assumed in the March 2010 Budget and that potential output would grow more slowly. The combined effects of these judgements implied that “the level of trend output at the start of 2015 is around 3¾ per cent below that implied by the assumption used for the March [2010] Budget economic forecast”;⁹ and
- our November 2011 EFO, which took on board further evidence of slow growth in potential output and less spare capacity: “Reassessing the size of the output gap and the outlook for growth in productive potential has led us to revise down our estimate of the level of potential output in 2016 by about 3.5 per cent since March [2011].”¹⁰

⁸ 2008 Pre-Budget Report, paragraph A.58, HM Treasury.

⁹ Pre-Budget forecast, June 2010, paragraph B4, interim OBR.

¹⁰ Economic and fiscal outlook, November 2011, paragraph 1.19, OBR.

Box 3.3: The IMF's growth shortfall: wider output gap or lower potential GDP?

In its April 2008 WEO, the IMF forecast that that UK real GDP would grow by 6.7 per cent between 2007 and 2010. By the time of its latest WEO in April 2014, the outturn was estimated at minus 4.3 per cent – giving an 11 percentage point shortfall against its pre-crisis forecast.

The IMF was swift and consistent in recognising the likely scale of the hit to growth from the crisis. By the time of its April 2009 WEO – when only early outturn data for growth in calendar year 2008 was available – it was already estimating that the shortfall would be 10.5 percentage points. Subsequent estimates ranged only between 9.5 and 11 percentage points (Chart B).

What *has* changed, based on our analysis of successive WEO forecasts, is the degree to which the IMF believes that this growth shortfall represents a widening of the output gap versus a loss of potential GDP (Chart C). In its April 2009 forecast, the IMF attributed 47 per cent of the growth shortfall to weaker-than-expected growth in potential GDP over the three years and 53 per cent to a widening of the output gap. By the time of its April 2011 forecast – the first for which provisional outturn data was available for the full three years – it estimated that 78 per cent of the shortfall was down to weaker-than-expected growth in potential, a further 6 per cent to the fact that it had over-estimated potential prior to the crisis and just 16 per cent to a wider output gap. By its latest forecast, it had moved further in the same direction: 63 per cent of the shortfall was due to weaker-than-expected growth in potential, 29 per cent to the over-estimation of potential pre-crisis and just 8 per cent to a wider output gap. So more than 90 per cent of the shortfall is now assumed to be permanent rather than temporary.

As we noted in Chapter 2, with regard to the forecasts and estimates made by the OECD, when potential GDP is estimated in part by running a smoothed line through actual GDP, there is a natural tendency for potential GDP to be revised down at and just before a period of weak or negative growth as that period of weakness lengthens. Interestingly, the share of the shortfall attributed to over-estimation of potential GDP pre-crisis has started to edge down slightly in the IMF's 2013 and 2014 forecasts as the pace of actual GDP growth has picked up.

Chart C: Shortfall in cumulative growth forecasts for 2007 to 2010

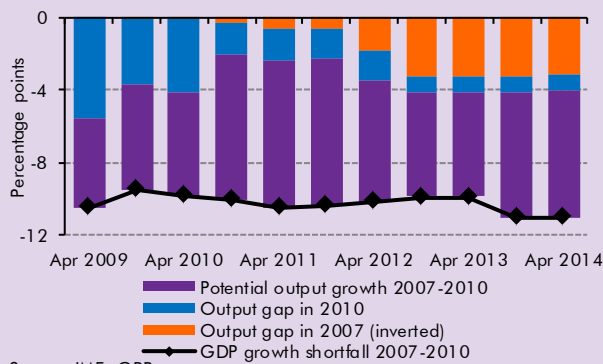
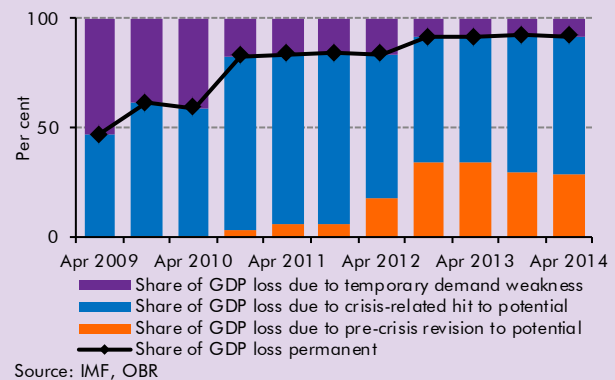


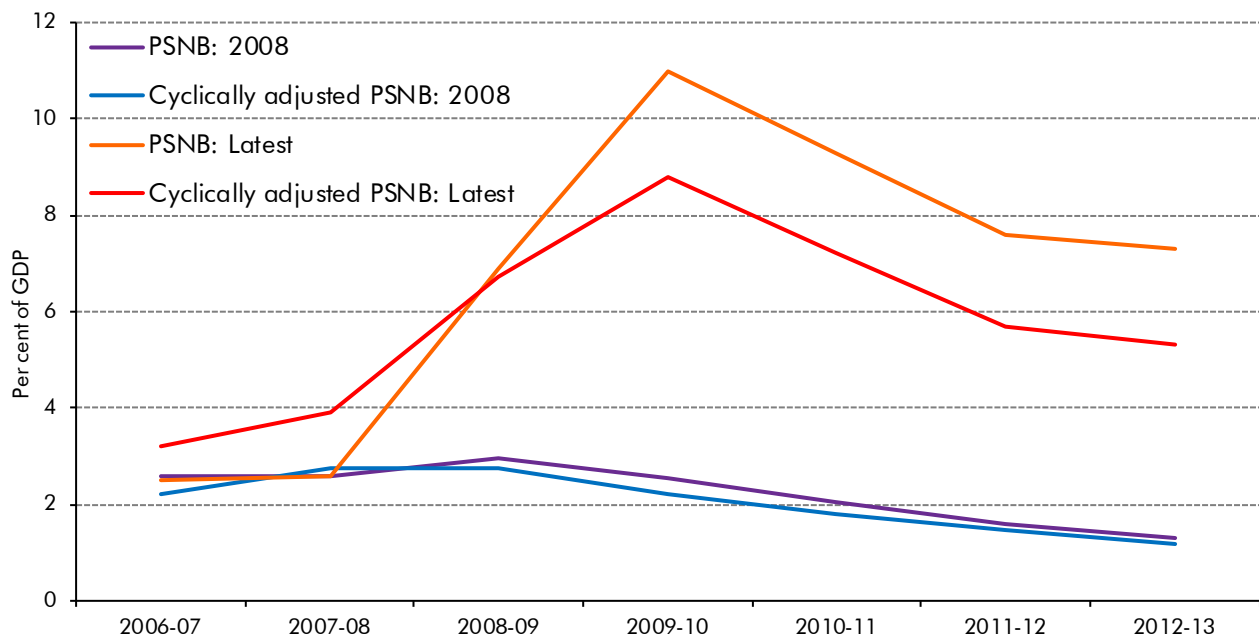
Chart D: Allocation of growth shortfall to temporary and permanent factors



The structural deficit

- 3.42 The size of the structural deficit for any given headline deficit depends on an estimate of the size of the output gap – the difference between actual and potential output – and how sensitive the public finances are to that output gap. Our estimates imply that every 1 percentage point change in the output gap leads to around a 0.7 per cent of GDP increase in the budget deficit.¹¹ As we stress in every *EFO*, the output gap and potential GDP are incredibly uncertain to estimate, even in retrospect.
- 3.43 In the Budget 2008 forecast, the small output gap implied that borrowing had been, and was forecast to be, almost entirely structural. This is shown in Chart 3.9, where the forecasts for both total net borrowing and structural net borrowing were around 2¾ per cent of GDP prior to the crisis, declining to around 1¼ per cent of GDP in 2012-13. The subsequent downward revisions to estimated potential output mean that we assume that most of the increase in borrowing seen during the crisis was structural. Indeed, by 2009-10, almost 9 percentage points of the 11 per cent of GDP total deficit is assumed to be structural. As discussed in Chapter 2, we also judge that the structural deficit was somewhat higher prior to the crisis than assumed in Budget 2008.

Chart 3.9: Headline and cyclically adjusted estimates of net borrowing

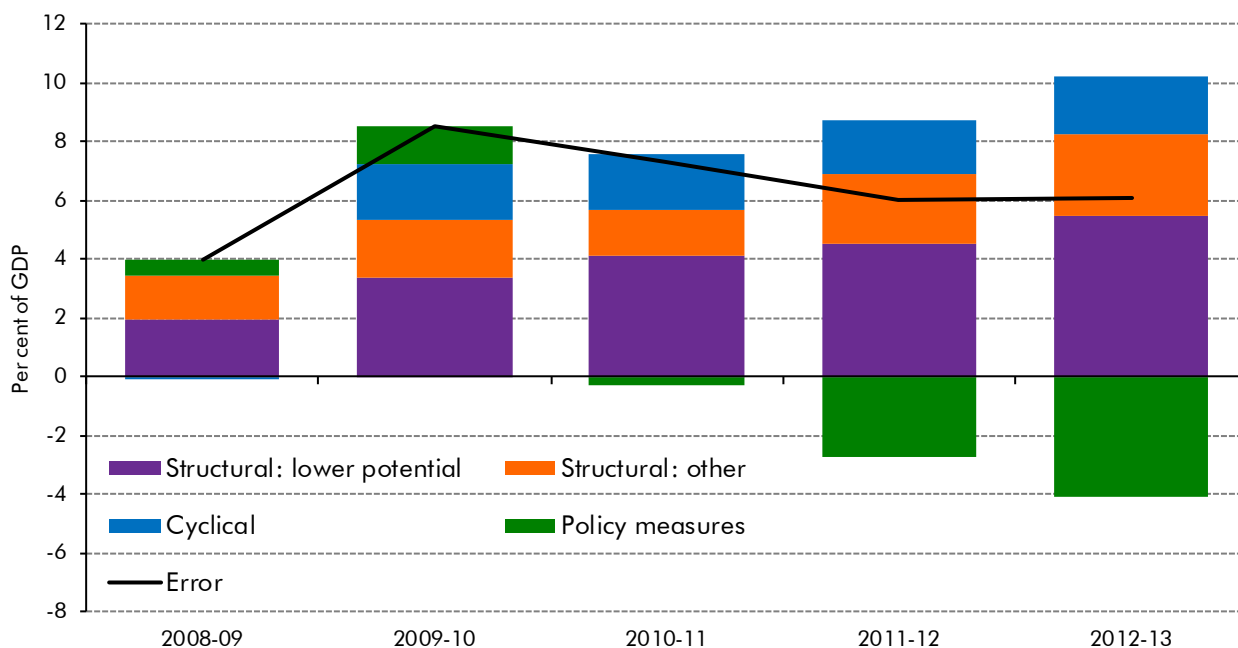


- 3.44 Having drawn the distinction between cyclical and structural borrowing within the overall deficit, we can revisit the errors in the Budget 2008 net borrowing forecast and assess the importance of each element. Chart 3.10 breaks down the errors in the Budget 2008 cash forecast for net borrowing into four components: cyclical borrowing, structural borrowing

¹¹ See *Working Paper No.3: Cyclically adjusting the public finances* on our website for more detail.

(arising from the downward revisions to potential output),¹² other non-discretionary structural factors (such as changes in the effective tax rate) and the direct impact of policy measures implemented after the forecast was made.

Chart 3.10: Errors in the Budget 2008 forecast for net borrowing



Source: ONS, OBR

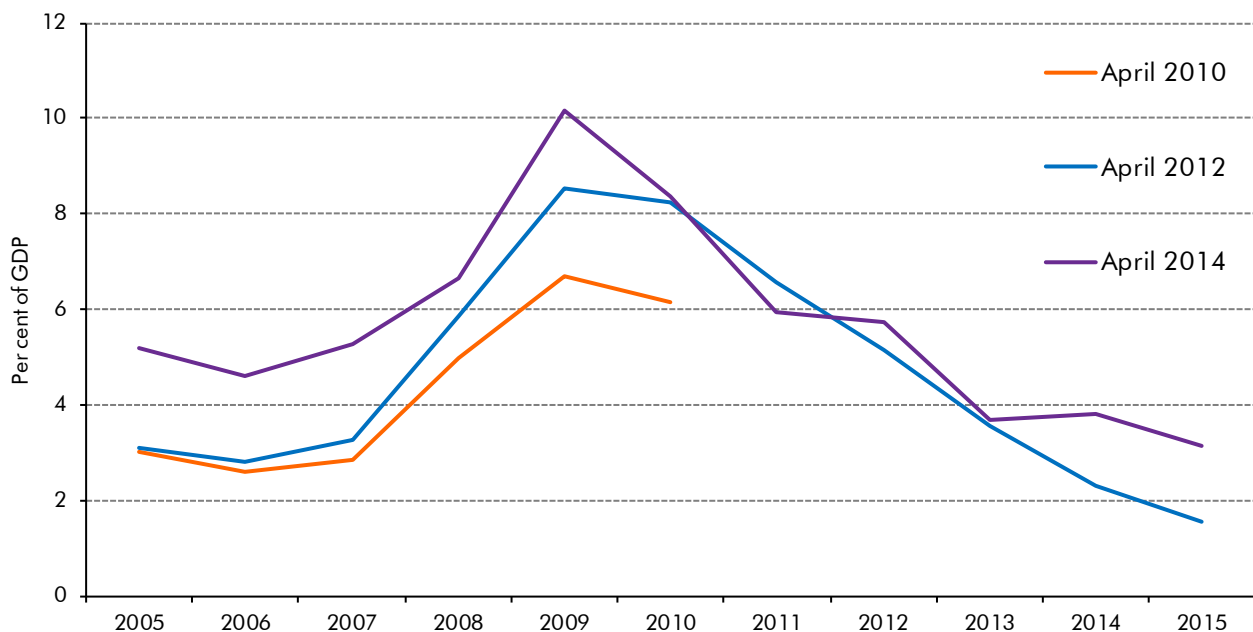
3.45 There is some uncertainty in this decomposition as it employs top-down cyclical adjustment and bottom-up policy costings that may not be mutually consistent, as well as each being subject to uncertainty in their own right. That said, the exercise implies that:

- the biggest source of error was failing to anticipate the hit to potential output and the increase in structural borrowing this would imply;
- other underlying changes to both receipts and spending increased structural borrowing further. In particular, falling real wages lowered the effective rate of income tax, and benefits and tax credits were uprated by more than nominal GDP increased;
- actual GDP fell even further short of the forecast than potential GDP, so there was additional cyclical borrowing too; and
- policy measures, as we shall see in the next section, increased the deficit relative to forecast in 2008-09 and 2009-10, had little impact in 2010-11 and reduced it thereafter as the policy stance shifted from stimulus in the midst of the crisis to consolidation in its wake.

¹² This assumes a 1 percentage point reduction in potential output increases structural net borrowing by 0.4 per cent of GDP. Our cyclical adjustment methodology implies a 1 percentage point change in the output gap leads to a bigger 0.7 per cent of GDP change in net borrowing, once also taking on board cyclical movements in the composition of GDP and asset prices that temporarily affect receipts (0.2) and cyclical unemployment that raises welfare spending (0.1).

3.46 Upward revisions to estimates of the structural deficit are not unique to the official UK forecasts, as we saw with reference to the OECD’s forecasts in Chapter 2. By way of further comparison, Chart 3.11 shows the International Monetary Fund’s estimates of the UK’s structural budget balance since 2009, as published in its April *World Economic Outlook* in selected years. Like us, the IMF judges the deterioration in the public finances through the crisis to have been largely structural and has also revised up its estimate of the pre-crisis structural deficit, having revised down its estimate of potential GDP (see Box 3.3). The IMF now believes that the structural deficit was 5.3 per cent of GDP in 2007, similar to the OECD’s figure of 4.9 per cent. Our current estimate – for public sector net borrowing rather than the general government deficit – would be around 3.9 per cent of GDP. The IMF judges that the structural deficit peaked at 10.2 per cent of GDP in 2009 and fell to 3.7 per cent by 2013. The OECD puts the structural deficit at 10.0 per cent of GDP in 2009 and 4.7 per cent in 2013. By 2015, forecasts of structural deficits are broadly similar between organisations with both ourselves and the IMF at around 3 per cent and the OECD at just under 4 per cent.

Chart 3.11: IMF estimates of the structural budget deficit

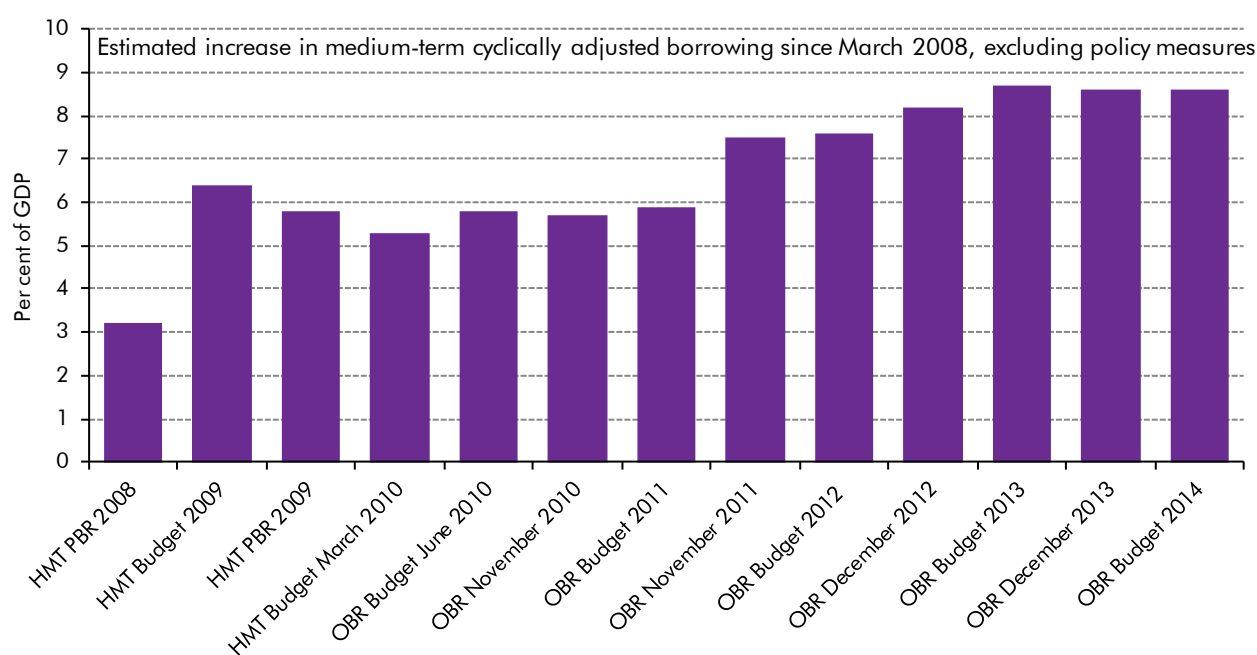


Source: IMF

3.47 One way to assess the fiscal challenge created and/or exposed by the financial crisis and recession is to ask how much the outlook for the structural budget deficit has increased since the Budget 2008 forecast. One way to approximate this is to look at the forecast for the structural budget deficit at each forecast horizon and to subtract the direct impact of the tax and spending policy measures that have been announced subsequent to Budget 2008 (which we quantify in the next section), a methodology used by the Institute for Fiscal Studies. These estimates of the ‘hole’ in the public finances that has opened up since Budget 2008 will incorporate the impact of lower potential output, but also other persistent changes in the borrowing forecast (for example, that we are more pessimistic about the prospects for North Sea oil production and revenues now than official forecasts in Budget 2008).

3.48 As Chart 3.12 shows, the Government's Pre-Budget Report forecast in November 2008 (after the failure of Lehman Brothers) implied an underlying deterioration in the structural fiscal position of 3.2 per cent of GDP since Budget 2008. By Budget 2009, this had increased to 6.4 per cent, as the Treasury revised up headline borrowing significantly in the wake of the sharp falls in output and asset prices after Lehman Brothers failed. (In hindsight, these upward revisions were excessive – the Budget 2009 forecast for headline borrowing in 2009-10 was too high by £18 billion.) The estimated structural deterioration was quite stable at around this level over the next 2½ years – the interim OBR's forecast revised down potential output, but it also moved to a central fiscal forecast rather than aiming to be deliberately cautious (as the Government claimed to have been), with these effects broadly offsetting. More significant changes came with our downward revisions to potential output in November 2011 and the persistence of below-trend output in December 2012. These caused the estimated size of the structural deterioration to increase to 7.5 per cent of GDP and 8.2 per cent of GDP respectively. The current estimate is 8.6 per cent of GDP.

Chart 3.12: The 'hole' in the public finances



Source: IFS

Tax and spending policy changes

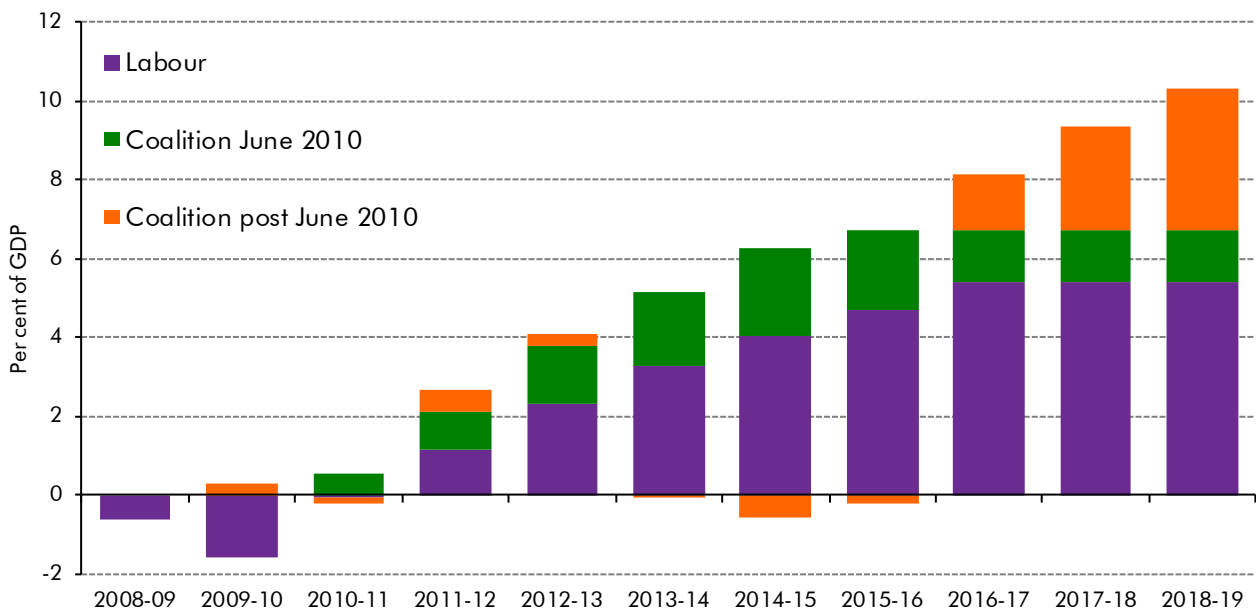
Summary of policy changes since Budget 2008

3.49 The evolution of the public finances since Budget 2008 has not been determined entirely by developments in the economy and by underlying drivers of particular receipts and spending streams. It has also been affected by the tax and spending policy changes announced since Budget 2008. Initially, these were expansionary and aimed at offsetting the worst of the recession. But the net giveaway was then reversed and a multi-year programme of fiscal consolidation – tax increases and spending cuts – was put in place.

- 3.50 In order to quantify the size and composition of the policy changes, we adopt the relatively straightforward approach used by the Institute for Fiscal Studies, which is simply to add up all the tax and welfare measures in Budget and Pre-Budget Report/Autumn Statement scorecards, as well as the impact of announced changes in departmental current and capital spending plans, after Budget 2008. We assume that the impact on receipts and spending of the tax and welfare measures would have been constant as a share of GDP beyond the end of the relevant scorecard horizon. We also assume that current and capital spending would have been constant as shares of GDP once the explicit plans in place in Budget 2008 had run their course. The data used in this section are sourced from the IFS's Green Budgets and the policy measures database published on our website.
- 3.51 These estimates are subject to significant uncertainty. For example, our approach assumes that the initial policy costings are correct and that they would remain constant as a share of GDP beyond the scorecard period – neither will be true in all cases. The choice of the 'unchanged policy' counterfactual for public spending also has a significant effect on the estimate of consolidation in later years. The Government assumes that spending would have grown in line with whole economy inflation in the absence of further policy changes, and would therefore have fallen steadily as a share of GDP. This would not be plausible over the long run and makes its spending cuts look less aggressive than our and the IFS's approach.
- 3.52 Chart 3.13 shows how the projected size of the consolidation has evolved:
- by the time of its final Budget in March 2010, the then Labour Government had announced consolidation plans that would mount gradually to reach 5.4 per cent of GDP by 2016-17;
 - when the Coalition Government was formed in May 2010, it argued that reducing the deficit was one of the most urgent issues facing the country. Its 'programme for government' stated: *"We will significantly accelerate the reduction of the structural deficit over the course of a Parliament, with the main burden of deficit reduction borne by reduced spending rather than increased taxes."*¹³ In its June 2010 Budget, the Coalition increased the eventual size of the consolidation to 6.7 per cent of GDP, sufficient to offset the interim OBR's upward revision to the expected structural deficit and also to aim for a better structural position at the end of the forecast. It also accelerated the consolidation, aiming to complete it a year earlier in 2015-16; and
 - in the face of further upward revisions to the expected structural deficits, and in order to aim for a balanced budget overall, in subsequent Budgets and Autumn Statements the Coalition has further increased the size of the consolidation to 10.3 per cent of GDP. But it has chosen to do so by extending the period of mounting consolidation by an extra three years to 2018-19, rather than by further accelerating it over the course of the current Parliament.

¹³ *The Coalition: our programme for government*, May 2010.

Chart 3.13: Policy measures since Budget 2008: period of announcement

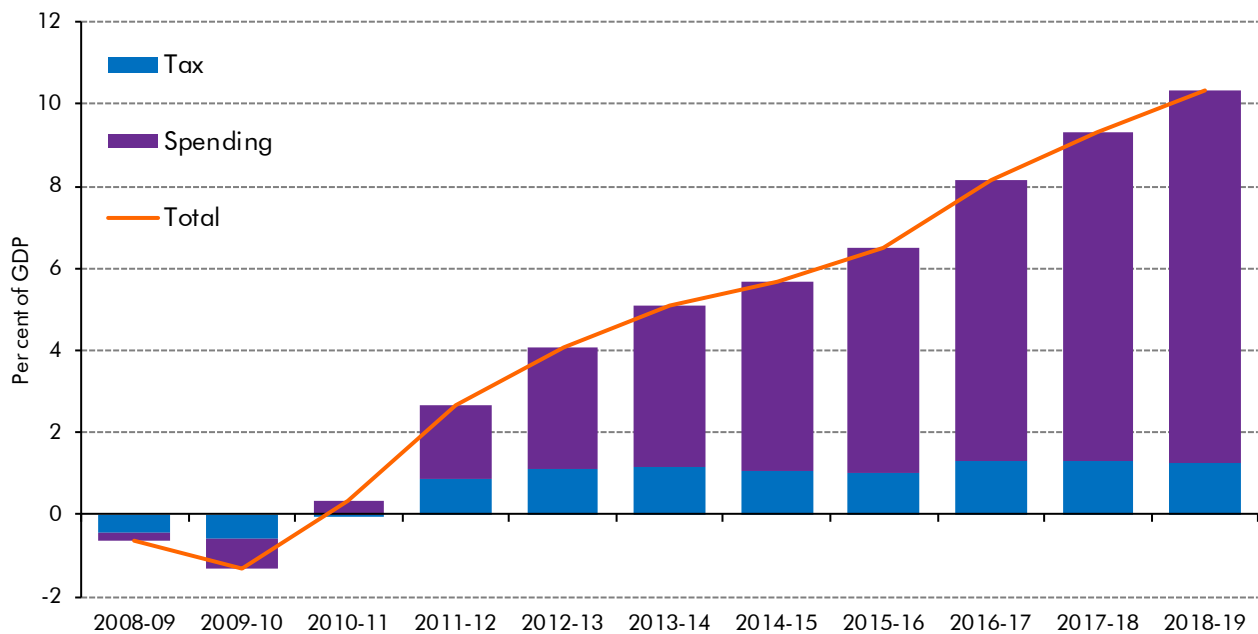


Source: IFS

Note: Recosting the introduction of the 50p income tax band at Budget 2012 means 'post-June 2010' measures affect prior years.

3.53 Chart 3.14 shows the measures announced since Budget 2008 broken down between net tax increases and net spending cuts. In the first two years after the crisis hit, fiscal policy provided a stimulus through policies such as the temporary VAT cut and bringing forward capital spending. This net giveaway amounted to slightly under 1.5 per cent of GDP by 2009-10 – roughly half tax cuts and half spending increases. This stimulus was withdrawn in 2010-11, with the main rate of VAT returned to 17½ per cent and public investment reduced sharply. The consolidation then increases in size relatively steadily over the subsequent eight years, with the main rate of VAT increased to 20 per cent and current and capital spending cut as a share of GDP. As the chart shows, the bulk of the planned tax increases were implemented relatively early. In contrast, the spending cuts build steadily over time and eventually account for around 85 per cent of the total consolidation.

Chart 3.14: Policy measures since Budget 2008: tax and spending



Source: IFS

Policy changes under the Labour Government

3.54 In consecutive fiscal events in the aftermath of the crisis, the Labour government announced policy measures designed to deliver fiscal stimulus in the short term and then begin the task of fiscal consolidation in the medium term. In turn:

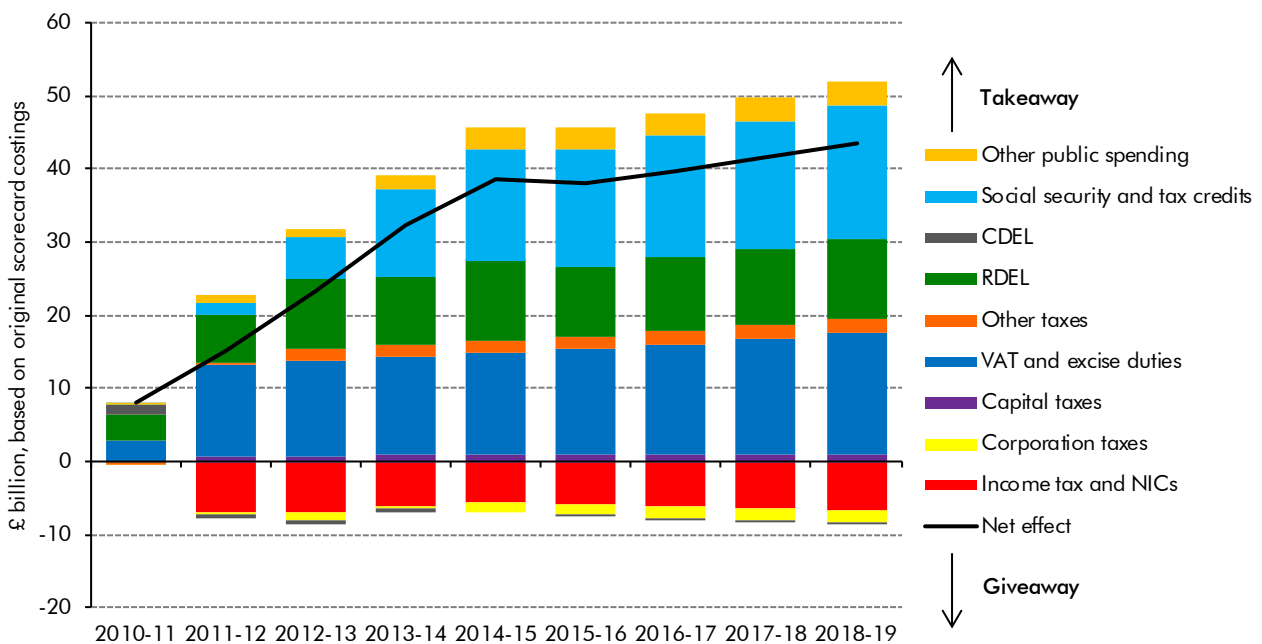
- with the crisis at its most intense, the 2008 Pre-Budget Report announced a package of stimulus measures that included a temporary cut in the main rate of VAT to 15 per cent, changes to the income tax personal allowance and basic rate limit and bringing forward £3 billion of capital spending from 2010-11 into 2008-09 and 2009-10;
- Budget 2009 provided further fiscal loosening in 2009-10, including through business rates deferrals, increased capital allowances and additional spending on DWP employment services, age-related payments to pensioners and housing supply. Policy was tightened from 2011-12, including via fuel duty increases and increasing the planned additional rate of income tax to 50p. More significantly, growth of current spending from 2011-12 was planned to fall to 0.7 per cent a year in real terms and net investment was cut to 1¼ per cent of GDP by 2013-14;
- the 2009 Pre-Budget Report tightened policy further from 2011-12, including through increases in NICs rates; and
- Budget 2010, Labour’s final pre-election Budget, included relatively small policy changes that neither loosened nor tightened the fiscal position significantly.

Policy changes under the Coalition Government

3.55 Using the detailed policy measures database available on our website, this section details the evolution of policy changes under the Coalition Government. Because the database only includes scorecard measures, it does not capture fully the spending consolidation that has been implemented through changes in the Government’s total spending assumption beyond the Spending Review years. For example, in Autumn Statement 2013, the spending assumption implied current spending on public services falling by around 1 per cent of GDP in 2018-19, but this did not appear in full on the Treasury scorecard. As such, when looking at the full effect of policy changes since Budget 2008, the IFS-based approach in the previous section is the most appropriate method.

3.56 Chart 3.15 shows the initial policy measures announced by the Coalition after the May 2010 election in the ‘emergency’ post-election Budget of June 2010 and in the Spending Review of October 2010. (At the time, forecasts and scorecards extended to 2015-16, so for subsequent years we have extended the estimates using the simple assumption that each measure’s effect remains constant as a share of GDP.) It shows that most of the extra £40 billion of planned fiscal tightening announced then was to be delivered by raising the main rate of VAT, reducing current spending on public services and cutting welfare spending.

Chart 3.15: Policy measures in the June 2010 Budget and Spending Review 2010



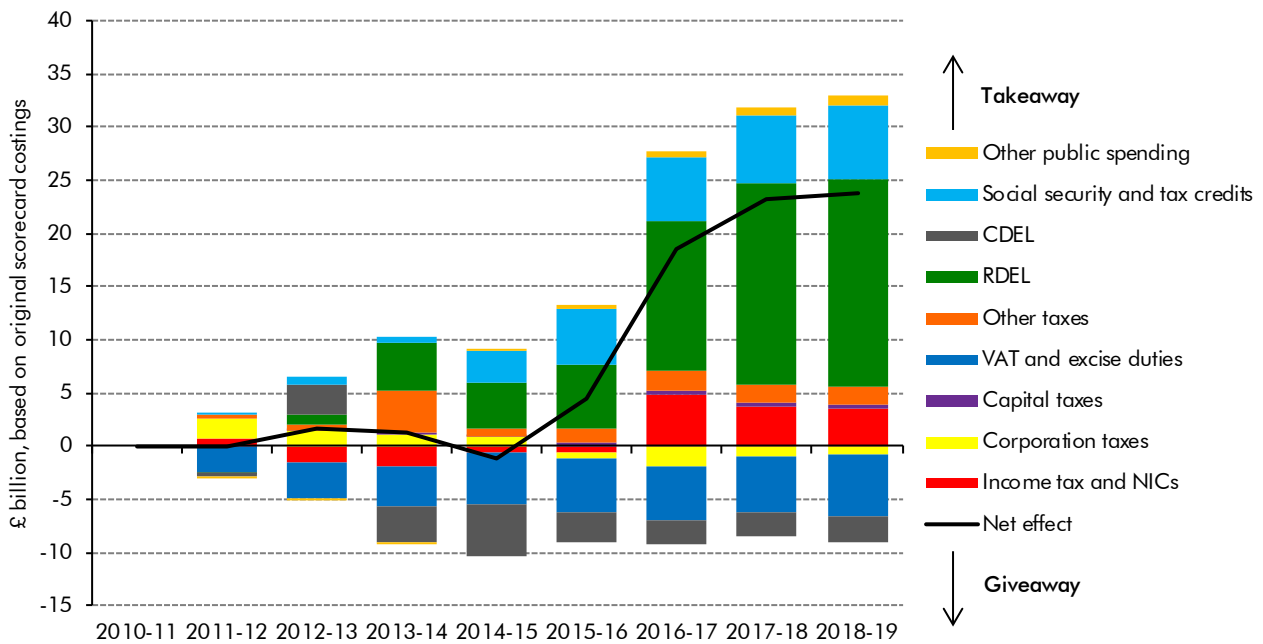
Source: OBR

3.57 The subsequent tax and spending changes announced by the Coalition have been broadly neutral for the consolidation during this Parliament, with the additional consolidation taking place in the next Parliament (Chart 3.16). During the current Parliament, giveaways such as further increases in the income tax personal allowance, freezes to fuel duty and increases in capital spending have been offset by further reductions in current spending on public services and welfare. But in the next Parliament, there will be a further £25 billion of

What happened instead

additional net tightening, consisting of substantial further cuts to current spending on public services and welfare and the abolition of the NICs contracting out rebate, partially offset by the lasting effect of tax giveaways such as raising the personal allowance and the fuel duty freezes announced for this Parliament.

Chart 3.16: Policy measures since Spending Review 2010

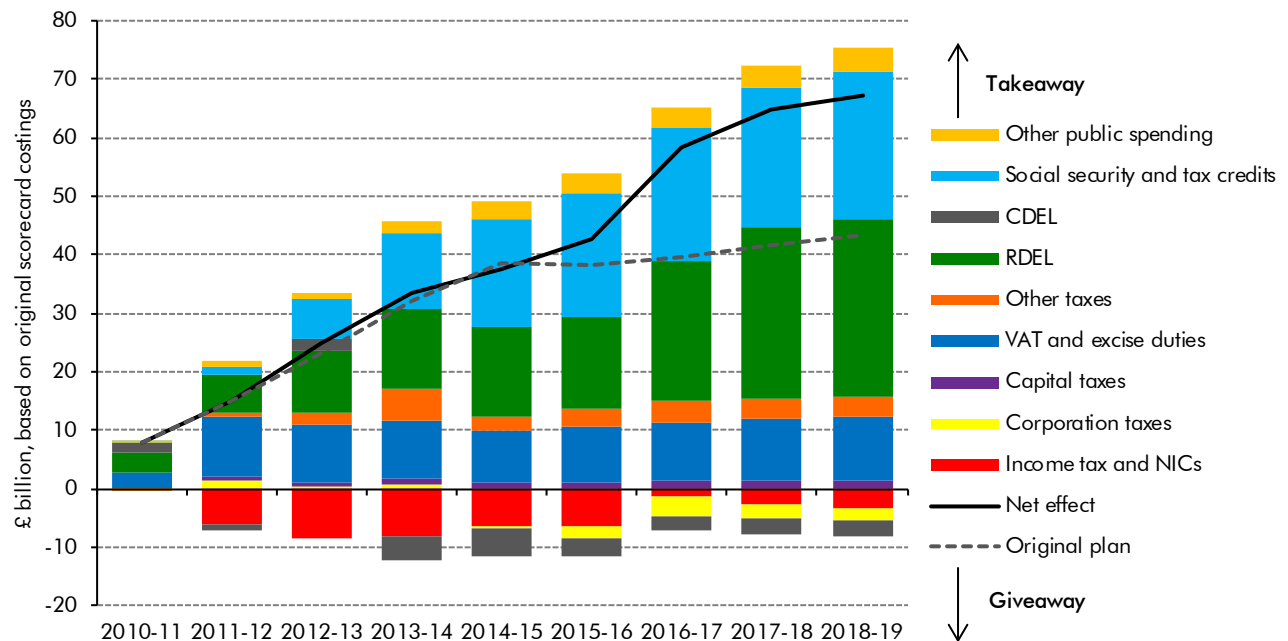


Source: OBR

3.58 Chart 3.17 combines all of the tax and spending measures announced by the Coalition. Current spending on public services, welfare spending and the increase in VAT remain the major sources of consolidation, with the NICs measure from 2016-17 also material. The VAT increase takes full effect in 2011-12, while the spending cuts cumulate over time. These measures easily offset the effect of the reductions in corporation tax, fuel duty and income tax (via raising the personal allowance).

3.59 From 2016-17, the NICs contracting out measure broadly offsets the cost of raising the personal allowance, though it is worth noting that around 60 per cent of the estimated saving comes from public sector employer contributions, thereby representing another forthcoming pressure on spending on public services.

Chart 3.17: Policy measures under the Coalition



Source: OBR

Box 3.4: The public finances without policy action

Having quantified the tax and spending measures announced since Budget 2008, we can subtract these from the forecasts for receipts and spending in each year to show paths for receipts and spending excluding the policy measures. This is done in Charts E and F.

Looked at either in cash terms or as a share of GDP, this suggests that in the absence of the consolidation there would have been a large and persistent gap between spending and receipts of around 10 per cent of GDP. This is consistent with our assessment that the financial crisis and recession caused and/or exposed a big deterioration in the structural budget balance.

However, we should not regard this ‘excluding policy measures’ calculation as a formal counterfactual estimate of the how the public finances would have looked in the absence of any consolidation measures. This is because the economy would probably have behaved very differently, which would affect receipts and spending, both in cash terms and as shares of GDP. Conventional ‘multiplier’ analysis suggests that near-term fiscal stimulus measures boost economic growth and tightening measures reduce it, at least temporarily, and we have made this assumption consistently in our own forecasts. But multipliers are typically used to estimate the impact of relatively small changes in fiscal policy. Forgoing the entire prospective fiscal consolidation package put in place by the current and previous governments would probably have had a negative impact on economic growth, given the likely consequences for the budget deficit, net debt, interest rates and the exchange rate that would have resulted.

Chart E: Spending and revenue with and without policy action (per cent of GDP)

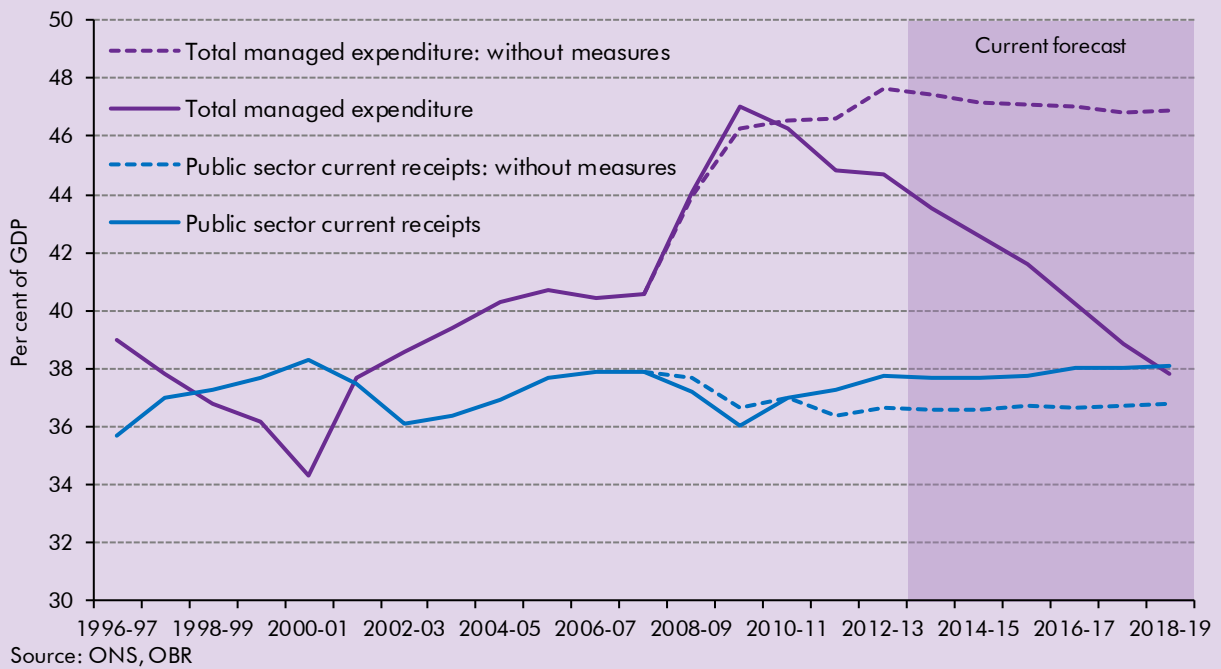
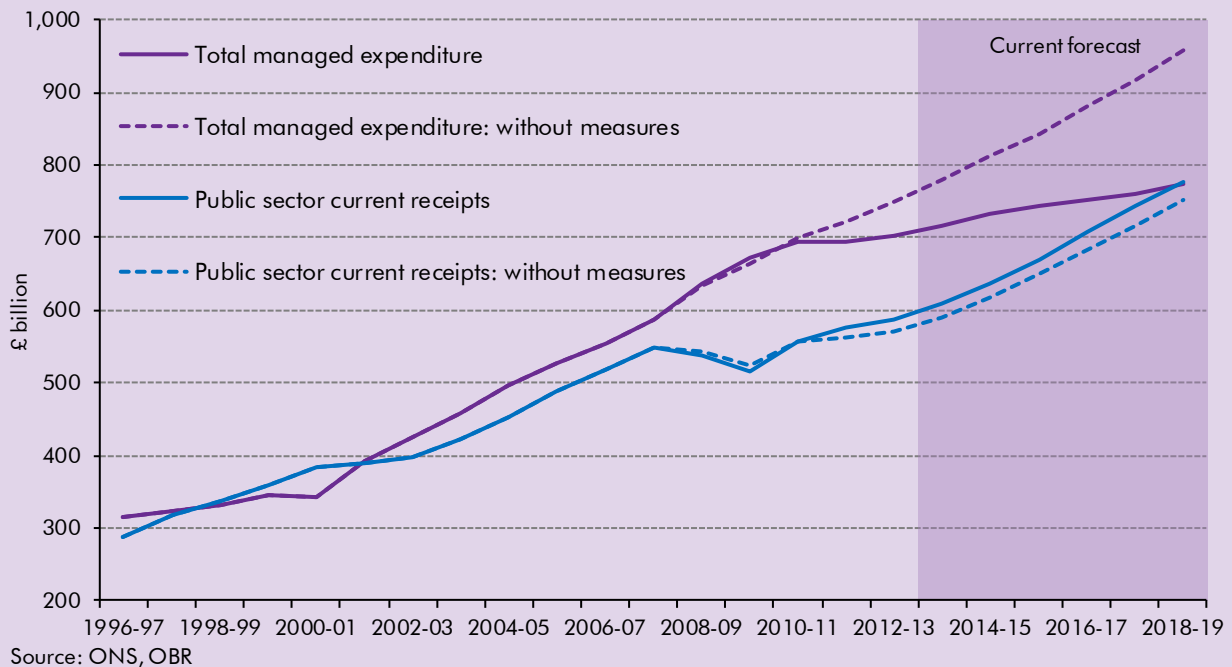


Chart F: Spending and revenue with and without policy action (£ billion)



Box 3.5: Quantifying ‘fiscal effort’

Commentators on fiscal policy are often interested not only in the size of the consolidation in any particular year, relative to a pre-crisis baseline, but also in how much the size of the consolidation changes from one year to the next – in other words the additional ‘fiscal effort’ the government undertakes in any given year to reduce the structural deficit.

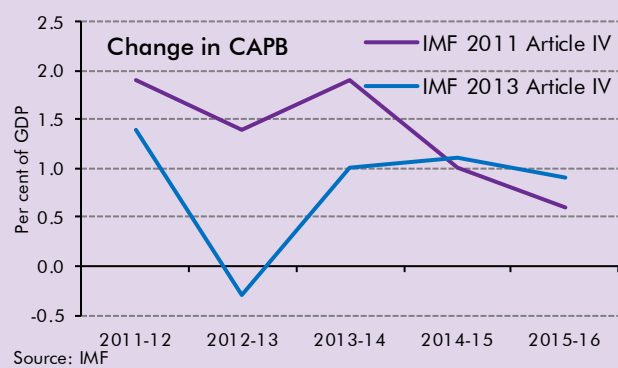
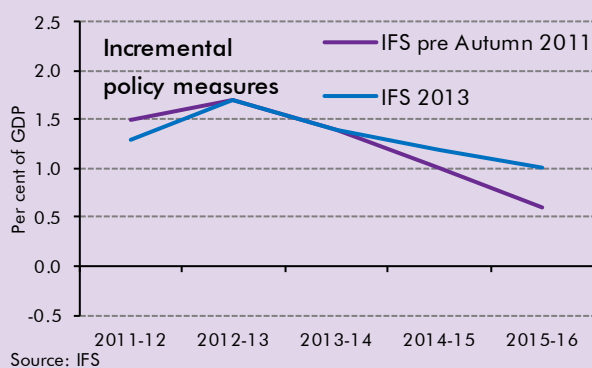
Given the approach that we and the IFS take to estimating the size of the fiscal consolidation, estimating fiscal effort from one year to the next simply involves adding up the new tax and spending measures that take effect in a particular year, relative to an appropriate baseline for the previous year. As we have discussed, this is a simple approach, but not without its uncertainties and awkward judgements. The most widespread alternative approach – often used by the international institutions when making cross-country comparisons – is to measure fiscal effort by the change in the structural budget balance from one year to the next.

Both are subject to uncertainty. Our bottom-up approach relies on estimates of the impact of individual policies on the public finances, which are rarely revised after the event. The top-down approach relies on estimating the output gap and the sensitivity of the public finances to it.

In normal times, both approaches would paint a similar picture. But the recent and sometimes large revisions to estimates of potential output from forecast to forecast have caused the top-down approach to deliver some potentially misleading conclusions. Specifically, the large downward revisions to potential output in 2012-13 changed the path of the cyclically adjusted fiscal aggregates significantly, which was interpreted by some as a discretionary fiscal loosening, whereas the path of incremental policy measures was little changed (Chart G).

While it is true that the Government chose not to offset the upward revisions that we and the IMF made to the estimated path of structural borrowing by tightening policy, that seems qualitatively different to announcing and implementing discretionary tax cuts or spending increases.

Chart G: Bottom-up and top-down measures of ‘fiscal effort’



Conclusion

- 3.60 The economy and the public finances both performed far worse between 2008-09 and 2012-13 than the Budget 2008 forecast had predicted. Most public attention focussed on the fall in real GDP, but more important for the evolution of the public finances were the weakness of nominal income and expenditure, unexpectedly big rises in consumer prices, higher unemployment (although much less high than the fall in output would have suggested), falling real wages, low interest rates and weak asset markets.
- 3.61 Borrowing increased sharply as a result, notably as weaker-than-expected nominal GDP significantly reduced cash receipts and pushed up the value of fixed cash spending plans as a share of GDP. Crucially, this deterioration in the budget deficit was judged to be largely persistent – thanks to a fall in potential output relative to the Budget 2008 forecast. Both the previous and current Governments recognised that this would take a major fiscal consolidation programme to address, one that is now mid-way through implementation.

4 Receipts

4.1 In Budget 2008, public sector receipts were expected to rise by more than 30 per cent in cash terms and by 0.7 per cent of GDP between 2007-08 and 2012-13, with income tax and onshore corporation tax providing most of the increase. This reflected the assumption that the economic slowdown would be relatively mild, with growth slowing slightly in 2008 but then recovering from 2009 onwards.

4.2 What happened instead was very different:

- receipts fell in cash terms in both 2008-09 and 2009-10, before then picking up. In previous recessions, receipts had continued to rise even as real GDP fell;
- receipts fell by 1.9 per cent of GDP between 2007-08 and 2009-10, rising by the same proportion of GDP over the subsequent three years; and
- receipts were £92 billion or 15 per cent below the Budget 2008 forecast by 2009-10. By 2012-13, the shortfall had increased to £128 billion or almost 18 per cent.

4.3 In this chapter, we look in more detail at how the path of receipts differed from the Budget 2008 forecast during the crisis and the early years of the consolidation.

Overview

4.4 Receipts fell by £33 billion between 2007-08 and 2009-10, instead of rising by £58 billion as forecast in Budget 2008. These were the first year-on-year falls in cash receipts since the Second World War – with the exception of 1992-93, when there was a small drop due to falls in interest and dividends receipts, as well as income and corporation tax. Chart 4.1 shows that in cash terms the fall between 2007-08 and 2009-10 was concentrated in capital taxes, income tax, onshore corporation tax, VAT, and interest and dividend receipts.

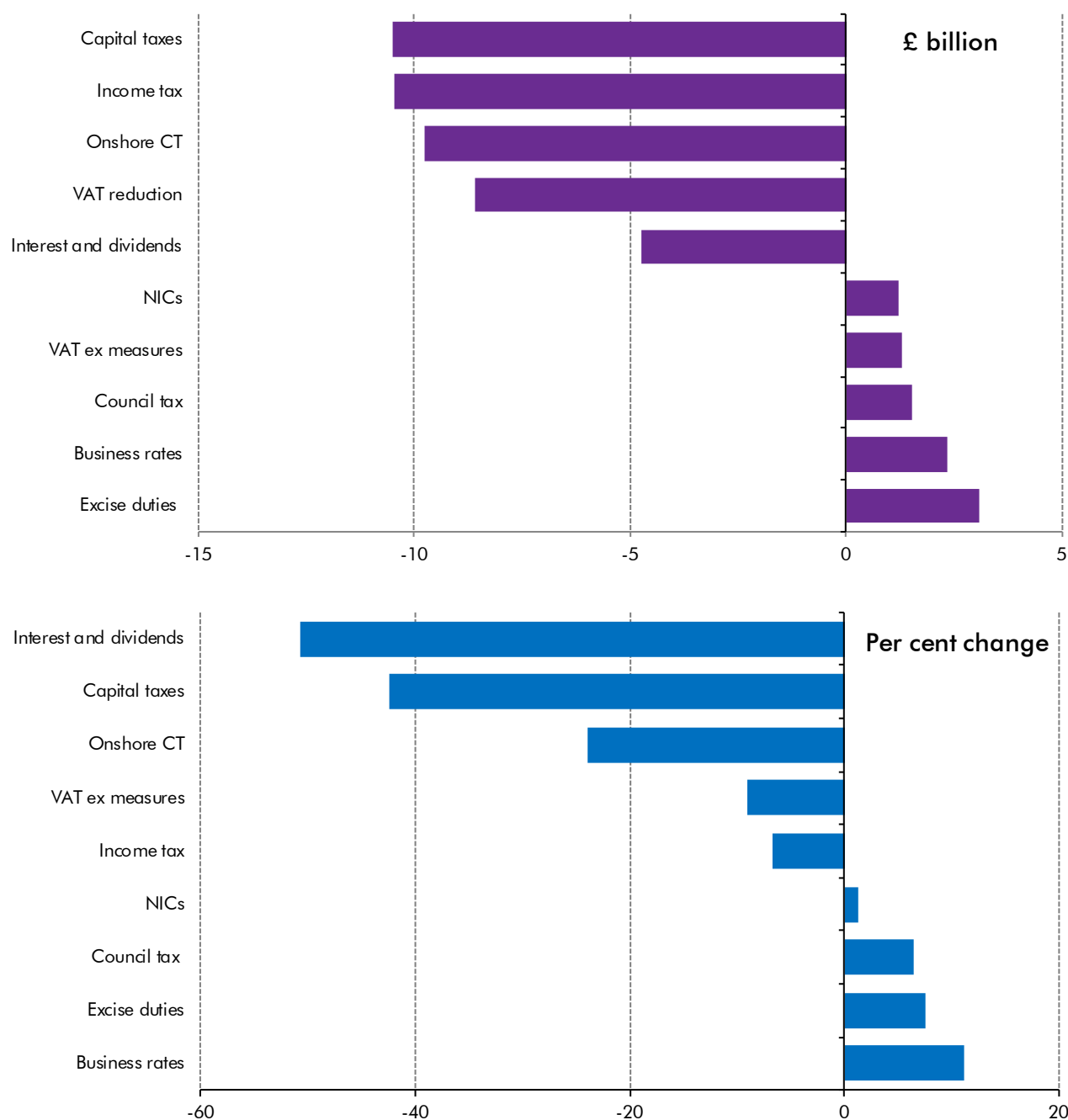
4.5 Interest and dividend receipts showed the sharpest proportionate fall, more than halving as short-term interest rates dropped from an average of 6.0 per cent to 0.8 per cent and as market gilt rates fell from 4.8 per cent to 3.2 per cent. The next steepest decline was in capital taxes, with receipts from stamp duty, capital gains tax and inheritance tax dropping by 42 per cent as equity prices, property prices, residential property transactions and interest rates fell sharply.

4.6 Income tax, onshore corporation tax and VAT receipts fell proportionately less sharply, but this was still very costly as they were much bigger sources of revenue to begin with. Income tax receipts dropped by 7 per cent, reflecting weak growth in wages and salaries and a fall

in the effective tax rate. Onshore corporation tax receipts dropped by 22 per cent, as profits fell and losses – particularly in the financial sector – mounted.

- 4.7 The 13 per cent fall in VAT receipts was more than accounted for by the temporary reduction in the standard rate of VAT from 17½ to 15 per cent for 13 months from the start of December 2008, which cost almost £9 billion in 2009-10 and roughly £12 billion in total. Excluding the rate change, VAT receipts rose by 1½ per cent, reflecting the fact that nominal consumer spending was broadly flat between the two years. Excise duties, business rates and council tax also held up reasonably well, reflecting relatively stable tax bases and/or rate increases in line with or higher than retail price inflation. Within excise duties, alcohol duties were boosted by rate increases well above inflation.

Chart 4.1: Change in receipts between 2007-08 and 2009-10



4.8 Having fallen by £33 billion between 2007-08 and 2009-10, receipts subsequently increased by £77 billion by 2012-13. As Table 4.1 shows, this corresponded to a fall of 1.9 per cent of GDP over the first two years, followed by an increase of the same amount over the subsequent three years. Policy measures – notably changes in the standard rate of VAT – accounted for almost half the initial decline as a share of GDP and more than all of the subsequent increase. The upswing in receipts was also bolstered by 0.4 per cent of GDP by transfers to the Exchequer related to quantitative easing. This implies an underlying fall in receipts of about 1½ per cent of GDP during the crisis that had not been recouped three

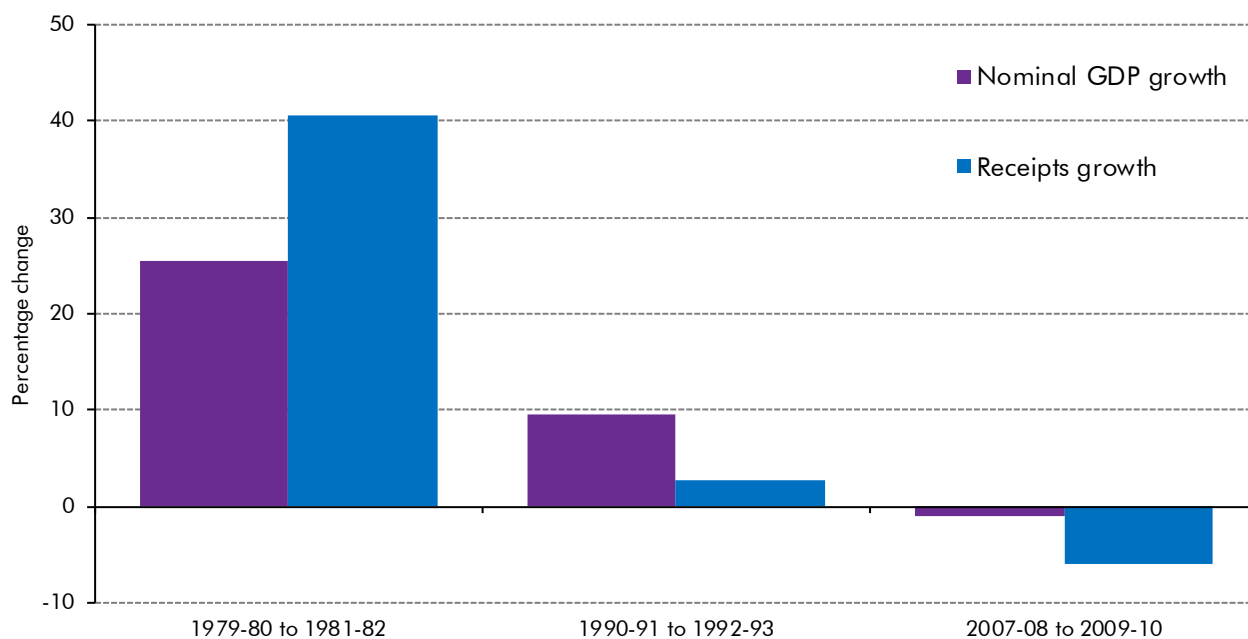
years later. This in part reflected the persistent loss of receipts from the financial sector, as well as the impact of falling real wages lowering the effective rate of income tax.

Table 4.1: Change in receipts as a share of GDP

	Per cent of GDP			
	07-08	09-10 v 07-08	12-13 vs 09-10	12-13
Income tax and NICs	17.5	-0.5	-0.6	16.4
Value added tax	5.6	-0.4	1.3	6.4
Onshore corporation tax	2.8	-0.7	0.1	2.3
UK oil and gas receipts	0.5	-0.1	-0.1	0.4
Fuel duties	1.7	0.1	-0.1	1.7
Business rates	1.5	0.2	0.0	1.7
Council tax	1.6	0.1	-0.1	1.7
Excise duties	1.1	0.1	0.0	1.3
Capital taxes	1.6	-0.7	0.1	1.0
Other taxes	2.0	0.1	0.5	2.7
Interest and dividend receipts (ex APF)	0.6	-0.3	0.2	0.5
APF dividend flows	0.0	0.0	0.4	0.4
Other receipts	1.3	0.1	0.0	1.4
Current receipts	37.9	-1.9	1.9	37.9
<i>of which: measures</i>	0.0	-0.9	2.0	1.2

4.9 When you consider that the recent financial crisis and recession delivered the largest peacetime shock to the public finances on record, it is striking how modest the swing in receipts has been as a share of GDP. The 1.9 per cent of GDP drop in receipts between 2007-08 and 2009-10 compares to a 2.4 per cent of GDP fall during the recession of the early 1990s, for example. As Chart 4.2 illustrates, nominal receipts and nominal GDP both increased between 1990-91 and 1992-93 – in contrast to the falls during the recent crisis – but the gap between them was larger in the 1990s than in the recent recession. The recession of the early 1980s was very different. Nominal receipts increased by more than 40 per cent between 1979-80 and 1981-82, while nominal GDP increased by 25 per cent, delivering an increase in receipts of 4.8 per cent of GDP. This reflected policy measures – such as the rise in the standard rate of VAT to 15 per cent and higher fuel duty rates – as well as higher profits in the subsequently privatised public sector utilities and a doubling of North Sea corporation tax as oil prices and production increased.

Chart 4.2: Nominal GDP and receipts growth in recent recessions



Source: ONS

4.10 The 1.9 per cent of GDP fall in receipts during the recent crisis was smaller even than the 2.2 per cent of GDP drop between 2000-01 and 2002-03. That followed the bursting of the dotcom bubble, which was accompanied by a relatively mild slowing in GDP growth. Much of the weakness in receipts during this period was concentrated in income tax and NICs, onshore corporation tax and – to a lesser extent – excise duties and capital taxes. Despite a growing economy, onshore corporation tax receipts fell by £4.3 billion, with receipts from the financial sector and life assurance companies both down by around £2 billion over the two-year period. Tax from financial sector bonuses also dropped. Excise duty receipts fell by around 0.3 per cent of GDP, in contrast to the 0.3 per cent of GDP rise in the recent recession. This reflected freezes in fuel duty rates in the early 2000s, whereas alcohol and tobacco duties were raised by more than inflation in the late 2000s. Fuel duty receipts were also depressed as spending on fuel fell relative to nominal GDP, rather than increasing as in the recent period – during which nominal GDP fell in absolute terms.

Receipts versus the Budget 2008 forecast: tax by tax

4.11 In Table 4.2, we show the 5-year cash forecasts for individual tax receipts from Budget 2008 as we now present them in our *Economic and fiscal outlooks*. Tables 4.3 and 4.4 then present the latest ONS outturns and the implied Budget 2008 forecast errors. (Back in 2008, the Government published these forecasts for just the first two years, only providing 5-year forecasts for selected taxes as shares of GDP.) We also present the forecasts on an accruals basis (when this is how they appear in the National Accounts), rather than on a cash basis as in 2008, again in line with our current *EFO* practice.

Receipts

4.12 The rest of the chapter looks at the key factors behind the main forecast errors. Of the £128 billion forecast error by 2012-13, income tax and NICs, onshore corporation tax and stamp duty land tax account for almost 90 per cent.

Table 4.2: Budget 2008 forecast for current receipts

	£ billion					
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Income tax (gross of tax credits) ¹	157.8	163.4	172.2	184.6	196.3	208.9
of which: PAYE	131.7	137.4	146.4	158.2	168.9	180.0
SA	23.0	23.9	23.9	24.4	25.1	26.3
Tax credits (negative income tax)	-4.7	-5.2	-5.5	-5.6	-5.7	-5.9
National insurance contributions	96.7	102.6	108.7	115.1	121.6	129.9
Value added tax	80.8	84.7	89.5	93.7	98.0	102.2
Corporation tax ²	47.0	51.9	56.3	61.0	64.4	68.0
of which: onshore	41.0	43.7	48.3	52.9	56.6	60.3
offshore	6.0	8.2	8.0	8.0	7.8	7.7
Corporation tax credits ³	-0.6	-0.6	-0.7	-0.7	-0.7	-0.8
Petroleum revenue tax	1.7	1.7	1.8	1.9	1.8	1.8
Fuel duties	24.9	25.7	27.1	28.7	29.6	30.5
Business rates	21.5	23.4	24.5	25.5	26.5	27.1
Council tax	23.7	24.9	26.0	27.3	28.6	30.1
VAT refunds	11.9	13.0	13.9	15.0	15.8	16.7
Capital gains tax	4.8	5.0	4.2	4.9	5.3	5.7
Inheritance tax	3.9	3.2	3.1	3.1	3.1	3.3
Stamp duty land tax	10.1	9.5	11.0	12.3	13.3	14.5
Stamp taxes on shares	4.2	4.0	4.2	4.4	4.6	4.8
Tobacco duties	8.1	7.6	7.8	7.9	7.9	7.9
Spirits duties	2.3	2.3	2.3	2.3	2.4	2.4
Wine duties	2.6	2.9	3.1	3.4	3.6	3.9
Beer and cider duties	3.3	3.5	3.6	3.7	3.9	4.1
Air passenger duty	2.0	2.1	2.5	3.1	3.6	3.9
Insurance premium tax	2.3	2.5	2.6	2.7	2.8	3.0
Climate change levy	0.7	0.7	0.7	0.7	0.7	0.7
Other HMRC taxes ⁴	5.2	5.5	5.9	6.2	6.4	6.6
Vehicle excise duties	5.6	6.1	7.1	7.9	8.5	9.0
Bank levy	0.0	0.0	0.0	0.0	0.0	0.0
Licence fee receipts	2.8	3.0	3.0	3.1	3.2	3.3
Environmental levies	0.4	0.4	0.4	0.5	0.5	0.5
Bank Payroll tax	0.0	0.0	0.0	0.0	0.0	0.0
Swiss capital tax	0.0	0.0	0.0	0.0	0.0	0.0
EU ETS auction receipts	0.0	0.0	0.0	0.0	0.0	0.0
Other taxes	3.8	3.8	4.0	4.1	4.2	4.4
National Accounts taxes	522.7	547.4	579.2	616.5	650.2	686.5
Less own resources contribution to EU	-5.0	-4.7	-4.9	-5.2	-5.4	-5.3
Interest and dividends exc. APF	7.9	7.0	7.0	7.4	7.7	7.8
Gross operating surplus	23.5	24.6	26.1	27.6	29.2	30.9
Other receipts	0.8	0.8	0.8	1.1	1.2	1.4
Current receipts exc. APF	549.9	575.2	608.2	647.4	682.9	721.1
APF dividend receipts	0	0	0	0	0	0
Current receipts	549.9	575.2	608.2	647.4	682.9	721.1
<i>Memo: UK oil and gas revenues⁵</i>	7.7	9.9	9.8	9.9	9.6	9.5

For footnotes, see Table 4.4.

Table 4.3: Outturn current receipts for the Budget 2008 forecast period

	£ billion					
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Income tax (gross of tax credits) ¹	157.1	150.9	147.2	153.3	152.7	152.3
of which: PAYE	132.7	127.0	125.7	130.4	132.4	132.0
SA	22.4	22.5	21.7	22.1	20.3	20.6
Tax credits (negative income tax)	-4.4	-5.6	-5.6	-5.6	-4.7	-3.0
National insurance contributions	95.4	96.6	96.6	97.7	101.6	104.5
Value added tax	80.9	75.8	73.5	86.3	98.1	100.7
Corporation tax ²	46.9	43.7	36.6	43.1	43.1	40.4
of which: onshore	41.2	33.9	31.6	36.2	34.2	36.0
offshore	5.7	9.8	5.0	6.9	8.8	4.4
Corporation tax credits ³	-0.6	-0.6	-0.8	-1.0	-0.9	-0.9
Petroleum revenue tax	1.7	2.6	0.9	1.5	2.0	1.7
Fuel duties	24.9	24.6	26.2	27.3	26.8	26.6
Business rates	21.2	22.8	23.5	23.8	25.2	26.3
Council tax	23.6	24.7	25.2	25.7	26.0	26.3
VAT refunds	11.6	12.0	11.3	13.2	14.0	13.8
Capital gains tax	5.3	7.9	2.5	3.6	4.3	3.9
Inheritance tax	3.8	2.9	2.4	2.7	2.9	3.1
Stamp duty land tax	10.0	4.8	4.9	6.0	6.1	6.9
Stamp taxes on shares	4.2	3.2	3.0	3.0	2.8	2.2
Tobacco duties	8.0	7.9	9.5	9.3	9.9	9.6
Spirits duties	2.3	2.4	2.7	2.7	2.9	3.0
Wine duties	2.6	2.8	3.0	3.1	3.4	3.5
Beer and cider duties	3.3	3.4	3.5	3.7	3.8	3.6
Air passenger duty	1.9	1.8	1.9	2.2	2.6	2.8
Insurance premium tax	2.3	2.3	2.3	2.5	3.0	3.0
Climate change levy	0.7	0.7	0.7	0.7	0.7	0.7
Other HMRC taxes ⁴	5.2	5.3	5.4	5.9	5.9	5.9
Vehicle excise duties	5.4	5.6	5.7	5.8	5.9	6.0
Bank levy	0	0	0	0	1.8	1.6
Licence fee receipts	2.9	3.0	3.0	3.1	3.1	3.1
Environmental levies	0.9	1.0	1.1	1.3	1.5	2.6
Bank Payroll tax	0.0	0.0	0.0	3.4	0.0	0.0
Swiss capital tax	0.0	0.0	0.0	0.0	0.0	0.0
EU ETS auction receipts	0.0	0.0	0.1	0.2	0.3	0.3
Other taxes	4.0	4.9	5.5	5.9	6.2	6.4
National Accounts taxes	521.1	507.2	491.7	530.4	551.2	557.0
Less own resources contribution to EU	-5.0	-5.1	-3.8	-5.3	-5.2	-5.3
Interest and dividends exc. APF	9.3	8.8	4.6	5.4	5.7	8.0
Gross operating surplus	24.6	26.3	24.5	26.0	26.1	27.4
Other receipts	-0.8	-1.0	-0.8	-1.0	-1.1	-0.1
Current receipts exc. APF	549.2	536.3	516.1	555.5	576.7	587.0
APF dividend receipts	0.0	0.0	0.0	0.0	0.0	6.4
Current receipts	549.2	536.3	516.1	555.5	576.7	593.5
<i>Memo: UK oil and gas revenues⁵</i>	<i>7.4</i>	<i>12.4</i>	<i>5.9</i>	<i>8.3</i>	<i>10.9</i>	<i>6.1</i>

For footnotes, see Table 4.4.

Receipts

Table 4.4: Budget 2008 current receipts forecast errors

	£ billion					
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Income tax (gross of tax credits) ¹	-0.6	-12.5	-25.1	-31.4	-43.6	-56.5
of which: PAYE	1.0	-10.4	-20.7	-27.8	-36.5	-48.0
SA	-0.5	-1.4	-2.2	-2.3	-4.8	-5.7
Tax credits (negative income tax)	0.2	-0.4	-0.1	0.1	1.0	2.9
National insurance contributions	-1.2	-6.0	-12.0	-17.4	-20.0	-25.4
Value added tax	0.1	-8.9	-16.0	-7.4	0.1	-1.5
Corporation tax ²	-0.1	-8.2	-19.7	-17.9	-21.3	-27.6
of which: onshore	0.3	-9.8	-16.6	-16.7	-22.4	-24.3
offshore	-0.3	1.6	-3.0	-1.2	1.0	-3.3
Corporation tax credits ³	0.0	0.0	-0.1	-0.3	-0.2	-0.2
Petroleum revenue tax	0.0	0.9	-0.9	-0.4	0.3	-0.1
Fuel duties	0.0	-1.1	-0.9	-1.4	-2.8	-4.0
Business rates	-0.3	-0.6	-1.0	-1.7	-1.3	-0.8
Council tax	-0.1	-0.2	-0.8	-1.5	-2.7	-3.8
VAT refunds	-0.3	-1.0	-2.7	-1.7	-1.9	-3.0
Capital gains tax	0.5	2.9	-1.7	-1.3	-1.0	-1.8
Inheritance tax	-0.1	-0.4	-0.7	-0.3	-0.2	-0.2
Stamp duty land tax	-0.2	-4.7	-6.2	-6.3	-7.2	-7.6
Stamp taxes on shares	0.0	-0.7	-1.1	-1.4	-1.8	-2.6
Tobacco duties	-0.1	0.3	1.7	1.5	2.0	1.7
Spirits duties	0.1	0.1	0.4	0.4	0.6	0.6
Wine duties	0.0	-0.2	-0.1	-0.3	-0.2	-0.4
Beer and cider duties	0.0	-0.1	-0.1	-0.1	-0.1	-0.5
Air passenger duty	0.0	-0.3	-0.6	-0.9	-1.0	-1.1
Insurance premium tax	0.0	-0.2	-0.3	-0.2	0.2	0.1
Climate change levy	0.0	0.0	0.0	0.0	0.0	0.0
Other HMRC taxes ⁴	0.0	-0.2	-0.5	-0.3	-0.5	-0.7
Vehicle excise duties	-0.2	-0.5	-1.4	-2.1	-2.5	-3.0
Bank levy	0.0	0.0	0.0	0.0	1.8	1.6
Licence fee receipts	0.0	0.0	0.0	-0.1	-0.1	-0.2
Environmental levies	0.5	0.6	0.7	0.8	1.0	2.1
Bank Payroll tax	0.0	0.0	0.0	3.4	0.0	0.0
Swiss capital tax	0.0	0.0	0.0	0.0	0.0	0.0
EU ETS auction receipts	0.0	0.0	0.1	0.2	0.3	0.3
Other taxes	0.3	1.0	1.5	1.9	2.0	2.1
National Accounts taxes	-1.6	-40.2	-87.6	-86.1	-99.0	-129.5
Less own resources contribution to EU	0.0	-0.5	1.1	-0.1	0.3	0.1
Interest and dividends exc. APF	1.4	1.8	-2.4	-1.9	-2.0	0.2
Gross operating surplus	1.1	1.7	-1.6	-1.6	-3.2	-3.5
Other receipts	-1.6	-1.8	-1.6	-2.1	-2.3	-1.4
Current receipts exc. APF	-0.8	-38.9	-92.1	-91.9	-106.2	-134.1
APF dividend receipts	0.0	0.0	0.0	0.0	0.0	6.4
Current receipts	-0.8	-38.9	-92.1	-91.9	-106.2	-127.6
<i>Memo: UK oil and gas revenues⁵</i>	<i>-0.3</i>	<i>2.5</i>	<i>-3.9</i>	<i>-1.6</i>	<i>1.3</i>	<i>-3.4</i>

¹ Includes PAYE and self assessment and also includes tax on savings income and other minor components.

² National Accounts measure, gross of reduced liability tax credits.

³ Includes reduced liability company tax credits.

⁴ Consists of landfill tax, aggregates levy, betting and gaming duties and customs duties and levies.

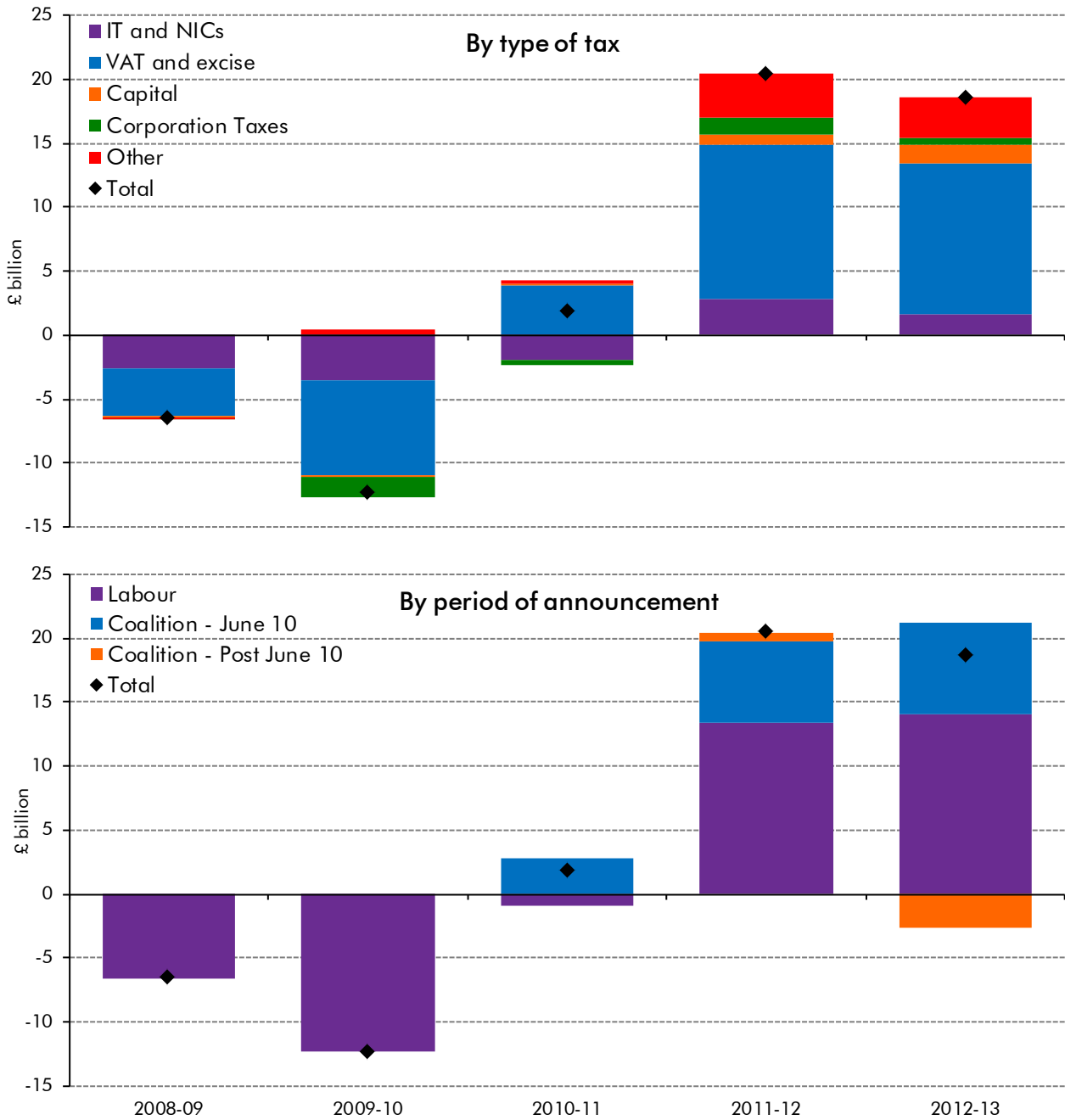
⁵ Consists of offshore corporation tax and petroleum revenue tax.

Note: Table is on accruals basis in line with national accounts definitions.

4.13 The main drivers of the shortfall in receipts were set out in Chapter 3. They were:

- **the drop in nominal GDP:** most tax bases relate to portions of nominal GDP (e.g. wages and salaries, nominal household consumption and nominal profits). Nominal GDP fell well short of the Budget 2008 forecast and (in contrast with previous recessions) also fell in absolute terms between 2007-08 and 2009-10;
- **labour market developments:** employment fell relatively modestly, given the sharp drop in output. However earnings growth has been very weak, mirroring the weakness of productivity;
- **asset markets:** share prices and residential and commercial property prices fell sharply, while property transactions halved;
- **the financial sector:** revenues were hit by lower profits and earnings in the sector, which lay at the centre of the crisis. This was important since financial companies had accounted for around a quarter of corporation tax receipts in the run-up to the crisis, while salaries and bonuses in the sector were more likely than those in other sectors to be subject to the higher rate of income tax;
- **high consumer price inflation relative to nominal GDP and earnings:** income tax receipts normally rise as a share of GDP, as earnings growth exceeds the inflation rate to which thresholds and allowances are indexed. But earnings growth has been lower than consumer price inflation in four of the last five years;
- **record low interest rates:** these have reduced the income that the government receives on its stock of assets and the income tax paid on savings income; and
- **tax policy measures:** the temporary reduction in the standard rate of VAT from 17½ to 15 per cent reduced receipts in 2008-09 and 2009-10, contributing to the shortfall against the Budget 2008 forecast in those years. But policy measures then boosted receipts modestly in 2010-11 and more significantly in 2011-12 and 2012-13. This reflected income tax increases for high earners and rises in employee and employer NICs rates announced by the Labour Government, plus the Coalition's decision to increase the standard rate of VAT to 20 per cent in its first Budget in June 2010. (The Coalition subsequently reversed a small part of its net tax increase in 2012-13.) Chart 4.3 shows the impact on receipts of the tax measures, broken down first by the type of tax and then by the timing of the announcement.

Chart 4.3: Tax measures since Budget 2008



Income tax and NICs

4.14 The income tax and NICs forecast in Budget 2008 assumed earnings growth averaging 4.7 per cent a year (close to its long-run trend), continued employment growth of 0.5 per cent a year, and earnings growth around 2 percentage points higher than inflation (consistent with expected growth in labour productivity). On this basis, receipts were expected to rise by £84.3 billion between 2007-08 and 2012-13, from 18.0 per cent to 18.5 per cent of GDP.

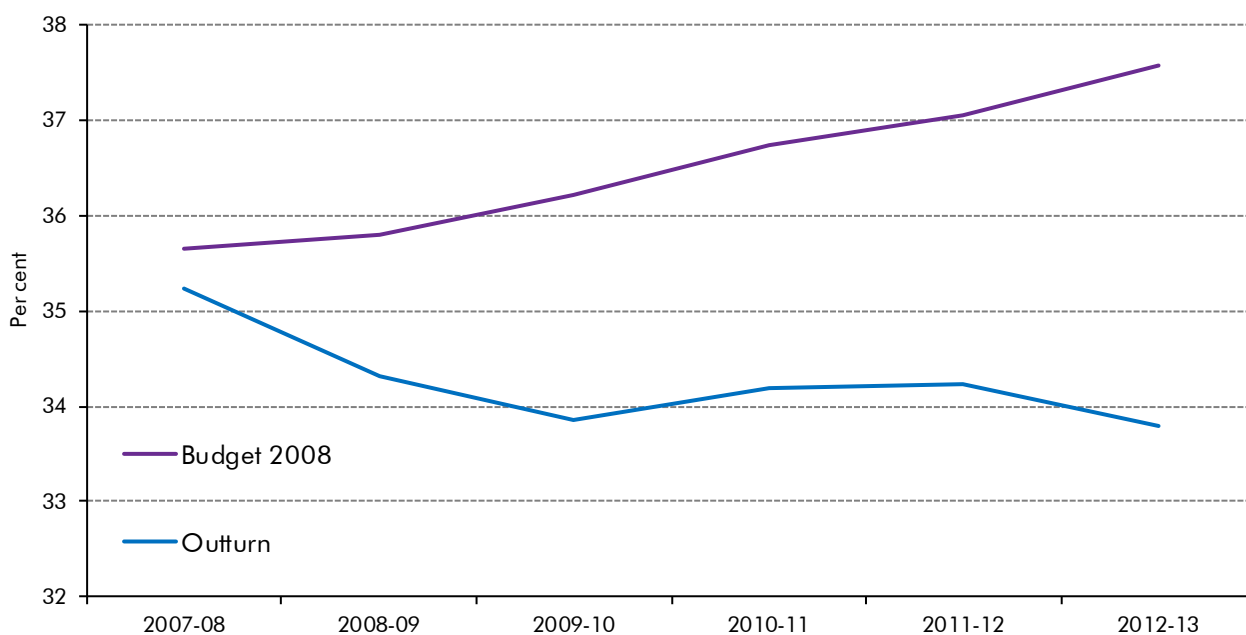
- 4.15 In the event, earnings grew by only 1.6 per cent a year on average, employment was flat and earnings growth lagged inflation by 1.6 percentage points. As a result, income tax and NICs receipts fell from 17.6 per cent of GDP in 2007-08 to 17.2 per cent in 2009-10 and then to 16.5 per cent in 2012-13, fully 2 percentage points below the Budget 2008 forecast. While some other tax streams started to recover as a proportion of GDP from 2009-10 onwards, subdued earnings growth meant that income tax receipts continued to lag growth in the economy. In cash terms, income tax and NICs receipts were only £4.2 billion higher in 2012-13 than in 2007-08, rather than rising by £84 billion as forecast. Abstracting from policy measures announced since Budget 2008, income tax and NICs receipts would only be £2.5 billion higher in 2012-13 when compared to 2007-08. The difference reflects increases in the NICs rate towards the end of the period.
- 4.16 With income tax and NICs accounting for around 45 per cent of total receipts, the forecast error for these receipts was always likely to be bigger in cash terms than for other taxes. By 2009-10, income tax and NICs accounted for around 40 per cent of the total receipts shortfall. By 2012-13, they accounted for nearly two-thirds of it.
- 4.17 Table 4.5 breaks down the forecast error into different components of income tax and NICs, and then breaks down the PAYE and NICs component into the impact of forecast errors for earnings growth, employment and changes in the effective tax rate. It shows that weak earnings growth has done much more to depress PAYE and NICs receipts than weak employment. With employment picking up from 2010 onwards, weak earnings growth explains around six times more of the forecast error than employment by 2012-13.

Table 4.5: Explaining the Budget 2008 error for income tax and NICs

	£ billion				
	2008-09	2009-10	2010-11	2011-12	2012-13
Budget 2008 forecast	266.0	280.9	299.8	317.9	338.7
Outturn	247.5	243.8	251.0	254.3	256.8
Difference	-18.5	-37.1	-48.7	-63.6	-81.9
of which:					
PAYE and NICs	-16.4	-32.7	-45.2	-56.5	-73.4
Self Assessment	-1.4	-2.2	-2.3	-4.8	-5.7
Other income tax	-0.7	-2.2	-1.2	-2.3	-2.8
PAYE and NIC forecast error	-16.4	-32.7	-45.2	-56.5	-73.4
of which:					
Earnings growth	-5.9	-10.6	-21.5	-28.4	-40.1
Employment	-0.7	-6.6	-6.7	-8.7	-6.8
Effective tax rate	-9.7	-15.5	-17.0	-19.3	-26.4

- 4.18 The other key factor explaining the shortfall in PAYE and NICs receipts is the lower effective tax rate on wages and salaries. Chart 4.6 shows that instead of rising by around 2 percentage points between 2007-08 and 2012-13, helped by positive fiscal drag, the effective tax rate fell by 1.4 percentage points.

Chart 4.4: Effective tax rates for PAYE and NICs receipts



Source: HMRC, OBR

4.19 In addition to the absence of fiscal drag, other factors lowering the effective tax rate include:

- a rise in the share of part-time workers in the workforce during the downturn. Between the second quarter of 2008 and the first quarter of 2010, full-time employees fell by over 900,000, while the number of part-time employees rose by over 100,000. Part-time workers are more likely to be lower-paid and thus have a lower effective tax rate;
- the plight of the financial sector, which has a sizeable proportion of high earners. The tax take from financial sector bonuses halved between its peak in 2006-07 and 2008-09. Bonuses then recovered, but the tax take was still almost 30 per cent below the pre-crisis peak by 2012-13. Nonetheless, overall PAYE and NIC1 receipts from the financial sector – including from basic pay as well as bonuses – recovered to their pre-crisis peak in 2010-11. This contrasts with corporation tax receipts from the sector, which were still less than half their pre-crisis peak even by 2012-13;
- policy measures, including the cost of the personal allowance and basic rate limit changes that compensated losers from the earlier 10p package (which had removed the 10p income tax band and lowered the basic rate of income tax to 20p), the 1 per cent rise in employee and employer NICs rates in 2011-12 (partly offset by a large increase in the employer NICs threshold) and the large real-terms increase in the personal allowance in both 2011-12 and 2012-13. The net effect of these measures was to lower receipts by an average of 0.2 per cent of GDP between 2008-09 and 2010-11 and to raise receipts by a maximum of 0.1 per cent by 2012-13.¹

¹ The effect of policy measures uses the latest view of the impact of the 50p additional rate of income tax on revenues, not the original policy costing.

4.20 Receipts from self-assessment (SA) income tax were also lower than the Budget 2008 forecast, despite a continued rise in the number of self-employed people through the recession. Between the start of 2008-09 and the end of 2012-13, the number of self-employed rose by around 340,000. The lower SA tax take reflected that:

- the rise in self-employment during the downturn was concentrated at the lower end of the income distribution, lowering the average effective tax rate on self-employment incomes. HMRC data indicate that the proportion of the self-employed reporting incomes less than the personal allowance rose from 21 per cent in 2007-08 to 35 per cent in 2011-12. For those subject to income tax, a higher proportion of the self-employed declared lower incomes in 2011-12 than was the case in 2007-08;
- receipts from savings and dividend income fell sharply, reflecting record low interest rates and weaker profits respectively. Tax deducted from savings income also fell sharply. This is scored as 'other income tax' in Table 4.5; and
- the effect of forestalling, as people shifted income forward to 2009-10 to pre-empt the introduction of the 50p additional rate of income tax on incomes over £150,000. This boosted 2009-10 liabilities (paid in 2010-11), but depressed them in following years.

Capital taxes

4.21 The Budget 2008 forecasts for equity prices, house prices and residential property transactions allowed for some near-term weakness in 2008-09, but assumed healthy growth thereafter. Equity prices were assumed to rise in line with nominal GDP growth and house prices in line with earnings growth from 2010-11 onwards. So the Budget 2008 forecast locked in most of the rises in asset markets seen prior to the crisis. Capital taxes were expected to be broadly flat as a share of GDP between 2007-08 and 2012-13.

4.22 Instead, there was a fall of £10.3 billion (45 per cent or 0.7 per cent of GDP) in capital tax receipts between 2007-08 and 2009-10, with each of the main taxes showing sharp falls. Capital gains tax was hit by lower equity prices and fewer asset disposals, given the adverse economic conditions. Receipts from inheritance tax were reduced by the reforms announced in the 2007 Pre-Budget Report and lower asset prices. Stamp duty land tax (SDLT) receipts were hit by the halving of property transactions from pre-crisis levels and the steep drop in commercial property values.

4.23 Table 4.6 provides a breakdown of the forecast error for SDLT receipts. With residential property transactions more than 40 per cent lower than in the Budget 2008 forecast each year from 2008-09 onwards, this is the main factor behind the receipts shortfall. Lower house prices were also a factor. The 'slab' structure of SDLT, where increases in the tax rate as the size of the transaction increases apply to the value of the whole transaction and not just to a marginal band, coupled with fixed nominal thresholds, mean that SDLT is highly geared to house price changes. The fall in house prices in 2008-09 and 2009-10 lowered the effective tax rate on SDLT from 1.9 per cent in 2007-08 to 1.7 per cent in 2009-10 as a larger proportion of sales took place at lower rates.

Table 4.6: Explaining the Budget 2008 forecast error for SDLT receipts

	£ billion				
	2008-09	2009-10	2010-11	2011-12	2012-13
Budget 2008 forecast	9.5	11.0	12.3	13.3	14.5
Outturn	4.8	4.9	6.0	6.1	6.9
Difference	-4.7	-6.2	-6.3	-7.2	-7.6
of which:					
Residential SDLT	-3.6	-4.5	-4.7	-5.4	-5.7
Commercial SDLT	-1.2	-1.7	-1.6	-1.8	-1.9
Forecast error for residential SDLT	-3.6	-4.5	-4.7	-5.4	-5.7
of which:					
Property transactions	-2.7	-3.2	-3.9	-4.2	-4.6
Other (including house prices and effective tax rate)	-0.9	-1.3	-0.8	-1.3	-1.1

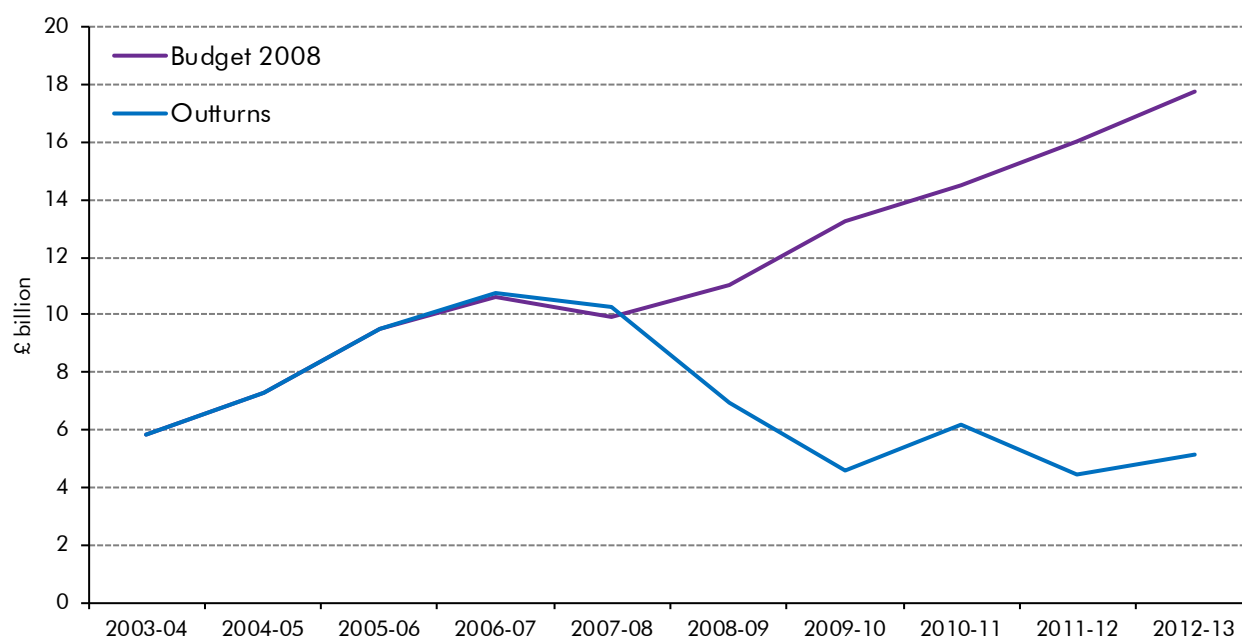
4.24 SDLT receipts began to recover from 2010-11 onwards, helped in particular by the recovery in the London housing market. The introduction of the 5 per cent and 7 per cent bands for residential property also helped boost receipts. But SDLT receipts only rebounded with any real strength in 2013-14, when receipts rose by 34 per cent as the upturn in house prices accelerated and as property transactions began to return to a level consistent with the long-run average duration of home ownership.

Onshore corporation tax

4.25 The Budget 2008 forecast for onshore corporation tax assumed growth in non-oil, non-financial profits of 5 to 6 per cent a year from 2008, and a sharp rebound in financial sector profits from 2009. By 2012, profits in the sector were forecast to be over 50 per cent higher than in 2007. Given this strong growth in the tax base, receipts were expected to rise by just under 50 per cent by 2012-13.

4.26 In the event, onshore corporation tax receipts fell by almost 25 per cent between 2007-08 and 2009-10, compared with the Budget 2008 forecast of an 18 per cent rise. The fall in receipts reflected lower profits in both sectors and the carrying back and forward of the unprecedented losses generated during the crisis. The steepest fall was in receipts from the financial sector, which dropped from £10.0 billion in 2007-08 to £4.5 billion in 2009-10, and were still over £5 billion below their peak in 2012-13. Chart 4.6 compares the Budget 2008 financial sector corporation tax forecast with the latest outturns. Receipts from industrial and commercial companies also fell between 2007-08 and 2009-10, but had surpassed their 2007-08 level in cash terms by 2012-13.

Chart 4.5: Budget 2008 financial sector corporation tax forecast



Source: HM Treasury, HMRC

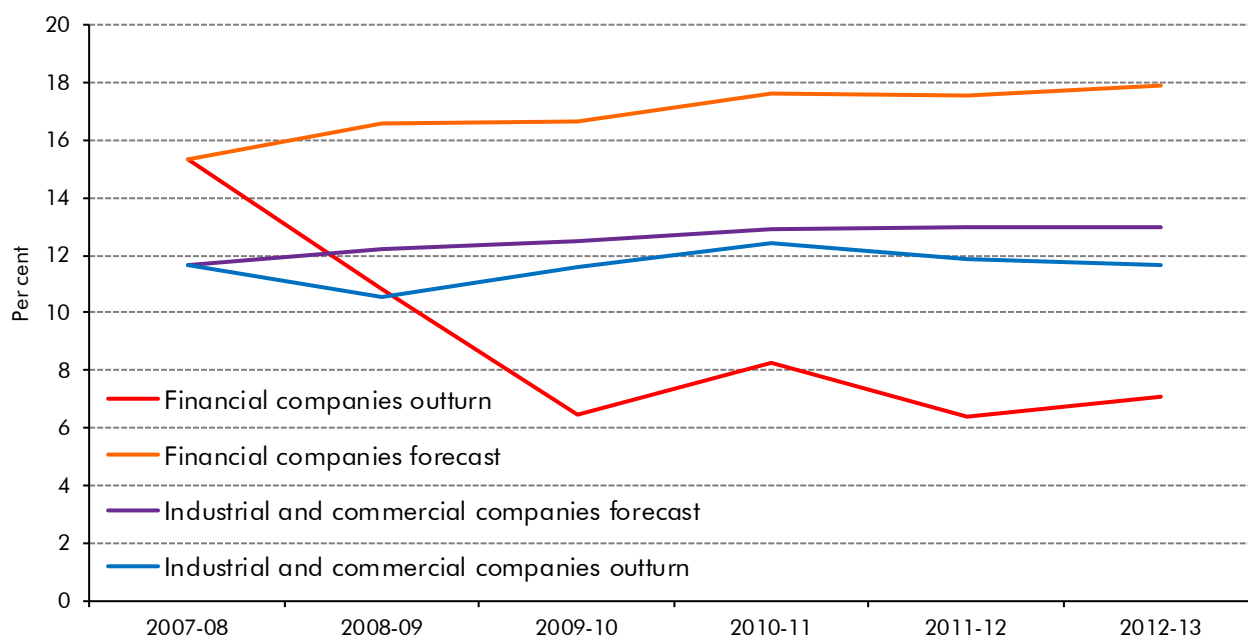
4.27 Onshore corporation tax was the second largest receipts forecast error in cash terms after income tax and NICs. By 2012-13, the Budget 2008 forecast was around 40 per cent too high. Table 4.7 breaks down the forecast error into those resulting from over-optimism in the growth in the tax base and errors on the effective tax rate and other factors.

Table 4.7: Explaining the Budget 2008 forecast error for onshore corporation tax

	£ billion				
	2008-09	2009-10	2010-11	2011-12	2012-13
Budget 2008 forecast	43.7	48.3	52.9	56.6	60.3
Outturn	33.9	31.6	36.2	34.2	36.0
Difference	-9.8	-16.6	-16.7	-22.4	-24.3
of which:					
Industrial and commercial companies	-5.7	-8.4	-8.4	-10.1	-11.7
Financial sector (exc Life)	-4.2	-8.5	-8.6	-11.8	-12.9
Other	0.1	0.2	0.3	-0.5	0.3
Industrial and Commercial Company CT forecast error	-5.7	-8.4	-8.4	-10.1	-11.7
of which:					
Non-oil, non-financial profits	-1.8	-6.4	-7.3	-7.5	-8.7
Effective tax rate	-3.9	-2.0	-1.1	-2.6	-3.0
Financial Sector (ex Life) CT forecast error	-4.2	-8.5	-8.6	-11.8	-12.9
of which:					
Financial company profits	-0.6	-1.4	-1.9	-4.2	-5.4
Effective tax rate	-3.6	-7.1	-6.7	-7.6	-7.5

4.28 Much of the shortfall in corporation tax from industrial and commercial companies reflects lower profit growth than expected. This was partially offset by lower capital allowance claims, as investment fell 20 to 30 per cent below the Budget 2008 forecast.

Chart 4.6: Effective tax rates for onshore corporation tax



Source: HMRC, OBR

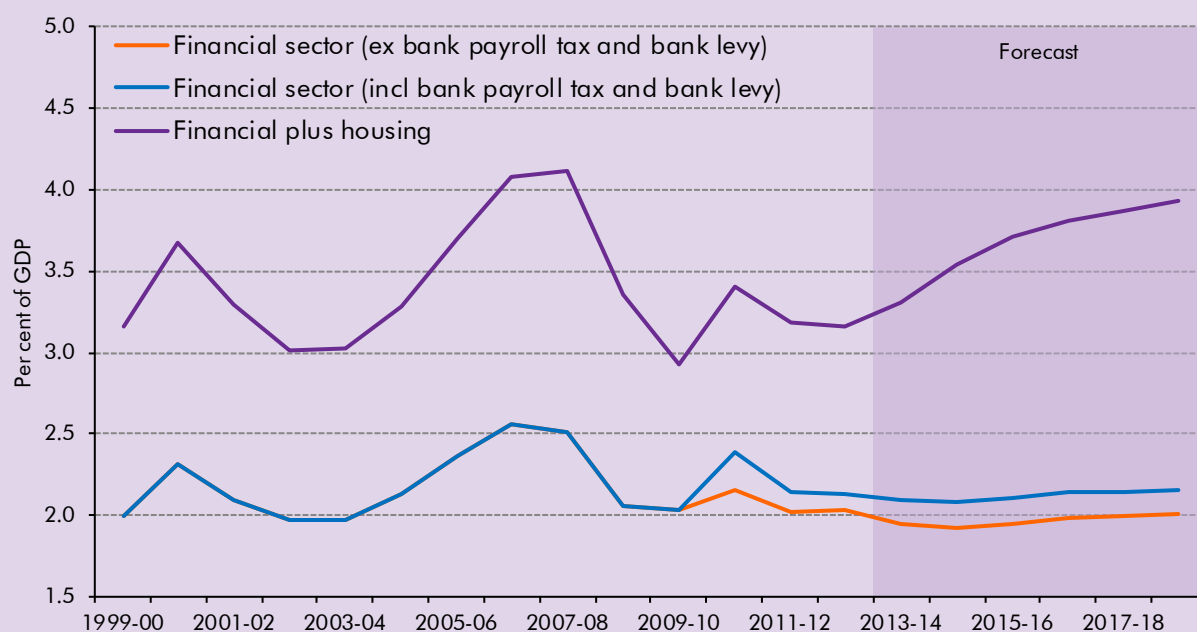
- 4.29** Financial sector corporation tax receipts were depressed in part by weaker-than-expected profits, specifically HMRC's measure of trading profits (which excludes losses). But even more important was a sharp fall in the effective tax rate on these profits. In particular, the financial crisis led to large losses that could be set against future profits. Trading losses carried forward and used averaged £2.7 billion a year in the four years before the crisis. From 2009-10 to 2018-19, we expect them to be £10 billion to £16 billion a year.
- 4.30** Policy measures had only a relatively modest downward effect on onshore corporation tax receipts during the Budget 2008 forecast period, reducing them by a maximum of 0.1 per cent of GDP. (The total fall in receipts was from 2.8 per cent of GDP in 2007-08 to 2.3 per cent of GDP in 2012-13.) The initial reductions in the main rate of corporation tax announced in the June 2010 Budget were largely offset by measures reducing the generosity of capital allowances. Beyond 2012-13, the further staggered reductions in the main rate to 20 per cent by April 2015, the introduction of the Patent Box, and the Budget 2014 increase in the annual investment allowance all reduce receipts. Thanks largely to these measures, we do not expect onshore corporation tax receipts to rise as a share of GDP through to 2018-19 in our March 2014 forecast.

Box 4.1: Financial and housing sector receipts

Receipts from the financial and housing sectors became increasingly important over the second half of the pre-crisis decade, rising from 3.0 per cent of GDP in 2002-03 to 4.1 per cent of GDP in 2007-08. They were then hit hard by the shock to confidence and credit during the crisis, dropping to 2.9 per cent of GDP in 2009-10. This accounted for two-thirds of the 1.9 per cent of GDP fall in the total receipts to GDP ratio. By 2012-13, these receipts had recovered only to 3.2 per cent of GDP, with most of that uptick accounted for the introduction of the bank levy.

We expect financial and housing sector receipts to remain below their pre-crisis peak throughout our latest forecast to 2018-19. Housing-related receipts from SDLT account for most of the expected increase over the current forecast period, as the average house price moves further above the 3 per cent SDLT threshold and as property transactions recover to their long-run trend.

Chart A: Financial and housing sector receipts as a share of GDP



Source: ONS, OBR

VAT

- 4.31 The path of VAT receipts has been heavily influenced by changes in the standard rate of VAT: the temporary reduction from 17½ to 15 per cent for 13 months from the start of December 2008 and the permanent rise to 20 per cent from January 2011. VAT receipts were £16 billion short of the Budget 2008 forecast by 2009-10, with policy measures reducing them by almost £9 billion (Table 4.8). By 2012-13, receipts were only £1.5 billion below forecast, with policy measures boosting them by almost £13 billion.
- 4.32 Abstracting from the impact of the measures, the main reason that VAT receipts were weak relative to forecast between 2007-08 and 2009-10 was that that nominal consumer spending barely grew over the two years rather than rising by around 10 per cent as

expected. The forecast error due to consumer spending and other economic determinants continued to widen over the remainder of the Budget 2008 forecast period.

4.33 VAT receipts were also affected by downturn-related falls in the share of consumer spending on standard-rated goods and a temporary rise in the VAT gap. Spending on durable goods, which are generally standard-rated, fell particularly sharply during the recession. In the early stages of the downturn, cash flow problems meant that the amount of unauthorised VAT debt rose sharply, pushing up the VAT gap – the difference between the theoretical tax liability and the actual payments received by HMRC. In addition, some firms used time-to-pay arrangements during the crisis to spread tax payments over a longer time period.²

4.34 With the move to fiscal consolidation, the government element of the VAT tax base was also weaker than expected. But there was also a partial offset later in the forecast from a decline in the VAT gap. As earlier unauthorised debts were repaid, the VAT gap by 2012-13 was 0.8 percentage points lower than in 2007-08. The Budget 2008 forecast assumed that the underlying VAT gap would increase by 0.5 percentage points a year.³

Table 4.8: Explaining the Budget 2008 forecast error for VAT receipts

	£ billion				
	2008-09	2009-10	2010-11	2011-12	2012-13
Budget 2008 forecast	84.7	89.5	93.7	98.0	102.2
Outturn	75.8	73.5	86.3	98.1	100.7
Difference	-8.9	-16.0	-7.4	0.1	-1.5
of which:					
Pre-Measures forecast error	-5.1	-7.4	-10.1	-12.0	-14.3
Measures	-3.8	-8.7	2.7	12.2	12.7
Pre-Measures forecast error	-5.1	-7.4	-10.1	-12.0	-14.3
of which:					
Nominal consumer spending	-1.4	-5.1	-5.4	-6.5	-7.4
Other economic determinants	-1.0	-2.7	-2.9	-3.7	-4.3
VAT gap	-3.0	0.0	1.7	2.3	2.4
Standard rated share of consumer spending	-0.3	-1.5	-1.7	-1.8	-2.0
Other	0.4	2.0	-1.8	-2.3	-2.9

Interest and dividend receipts

4.35 The interest income from the government’s stock of financial assets fell by just over 50 per cent between 2007-08 and 2009-10, reflecting the steep drop in both short-term and long-term interest rates. The Budget 2008 forecast had assumed these interest rates would remain close to 5 per cent over the two years, but in the event short-term rates dropped to 0.8 per cent and market gilt rates to 3.2 per cent. But, as a relatively small source of receipts, this large proportionate fall reduced total receipts by only 0.3 per cent of GDP.

² The level of the tax gap is much lower in outturn than in Budget 2008 across the forecast period because of changes to the VAT theoretical tax liability (VTTL), but it is changes from year to year that matter for when decomposing forecast errors.

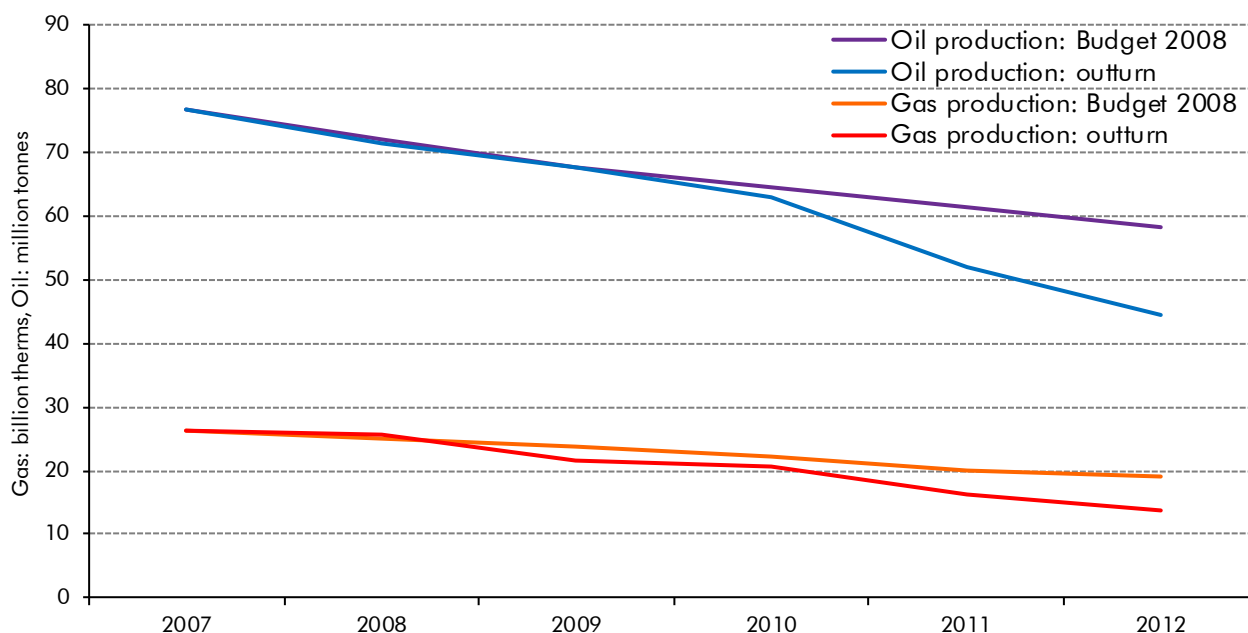
³ The VAT gap assumption was one of the forecast assumptions designed by the Treasury to be deliberately cautious. See, for example, NAO *Audit of assumptions for Budget 2010*, March 2010.

- 4.36 Interest and dividend receipts then rose by 0.2 per cent of GDP between 2009-10 and 2012-13. However, much of this reflects a one-off receipt of £2.3 billion when the Special Liquidity Scheme ended in 2012-13 and the ONS decision to treat Bradford and Bingley and Northern Rock (Asset Management) as part of central government as they are now closed to new banking business and will simply be unwound over time. Their interest income (mainly from mortgage interest payments) adds over £2 billion to receipts from 2010-11 onwards.
- 4.37 Beyond 2012-13, interest and dividend receipts are expected to pick up more strongly. Interest rates are expected to start to rise and this will combine with a stock of government assets that is already substantially higher than prior to the crisis – government holds larger foreign exchange reserves, more deposits at the Debt Management Office and a bigger stock of student loans.

Oil and gas revenues

- 4.38 Oil and gas revenues are the most volatile of the major receipts streams. The average absolute change in oil and gas revenues over the last ten years has been nearly 35 per cent, compared with just 5 per cent for income tax and 7 per cent for VAT. This volatility was evident between 2007-08 and 2012-13, with oil and gas revenues £2.5 billion higher than expected in 2008-09 and £3 billion to £4 billion lower in both 2009-10 and 2012-13.
- 4.39 This volatility reflects fluctuations in oil prices, production and expenditure. Oil prices fell from a peak of almost \$150 a barrel in mid-2008 to a low of less than \$40 a barrel in early 2009, before rising again to more than \$120 a barrel in mid-2011. The weakness in receipts in 2012-13 (and in subsequent years in the March 2014 *EFO* forecast) reflects a drop in oil and gas production over 2011 and 2012 of around 30 per cent. The Budget 2008 forecast had assumed a fall in production of between 5 and 6 per cent a year, broadly in line with what had been seen since production peaked in 1999.
- 4.40 Capital expenditure, which can be set against tax, was also more than double the level assumed in the Budget 2008 forecast. This reflected strong cost pressures and spending on several large projects. The combination of lower production and higher expenditure more than offset the upward effect on oil and gas revenues from higher oil prices and the Budget 2011 decision to raise the supplementary charge from 20 per cent to 32 per cent.

Chart 4.7: Oil and gas production: forecasts and outturns



Source: DECC, HM Treasury, OBR

Excise duties

4.41 Excise duties (fuel, tobacco and alcohol) rose by 0.25 per cent of GDP during the crisis. This reflected above-inflation increases in duty rates, particularly for alcohol and tobacco, and less volatile tax bases than for many other taxes. Budget 2008 announced that alcohol duties would rise by 6 per cent above inflation in 2008 and then by 2 per cent above inflation each year through to 2013. Further permanent duty rises on alcohol and tobacco were announced in the 2008 Pre-Budget Report, to offset the impact on prices of the temporary reduction in the VAT rate. Alcohol duty rates were 25 per cent higher after Budget 2010 than they had been prior to Budget 2008, compared to an 11 per cent increase in fuel duty rates.

4.42 From 2009-10 onwards, excise duties resumed their long-term decline as a share of GDP, consistent with downward trends in the consumption of fuel, tobacco, beer and spirits. In addition, fuel duty – which raises more revenue than alcohol and tobacco duty combined – was cut by 1p in April 2011 and frozen until September 2015.

Business rates and council tax

4.43 Receipts from council tax and business rates rose by 0.3 per cent of GDP between 2007-08 and 2009-10, reflecting the fact that the tax bases for domestic and non-domestic properties are very stable, in part because the stock of buildings changes little from year to year. Receipts then fell marginally as a share of GDP through to 2012-13, reflecting council tax freezes in both 2011-12 and 2012-13.

Other taxes

- 4.44 Receipts from other taxes rose by 0.7 per cent of GDP to 2.7 per cent of GDP between 2007-08 and 2012-13. This reflects the introduction of the bank levy, the introduction or scaling up of environment-related taxes and levies (e.g. EU ETS receipts, renewables obligation and carbon reduction commitment), higher rail franchise premia payments and reforms to tax credits that have reduced the element scored as negative tax.

Conclusion

- 4.45 Measured in cash terms, public sector receipts fell well below the Budget 2008 forecast between 2007-08 and 2009-10, reflecting the unexpected weakness of nominal GDP and the components within it that form the major tax bases. Indeed cash receipts and nominal GDP both fell in absolute terms in those two years, a very rare event.
- 4.46 Measured as a proportion of GDP, the decline in receipts during the crisis looks much less dramatic – notwithstanding the temporary cut in VAT. Indeed the drop of 1.9 per cent of GDP was smaller than those seen during the previous recession in the early 1990s and in the wake of the bursting of the dotcom bubble in the early 2000s. The decline was then reversed, taking receipts back to their pre-crisis share of GDP by 2012-13. Receipts are forecast to be just 0.2 per cent of GDP above their pre-crisis level by 2018-19.
- 4.47 Policy measures – notably the changes in the main rate of VAT – accounted for almost half the fall in receipts as a share of GDP to 2009-10 and more than all the subsequent recovery to 2012-13. This implies that there was an underlying deterioration in receipts of around 1½ per cent of GDP in the crisis that had not been fully recouped by 2012-13. This largely reflects the enduring loss of receipts from the financial sector and persistently weak earnings growth, which lowered the average effective rate of income tax.

Receipts

5 Public spending

- 5.1 The Budget 2008 forecast predicted that public spending would remain within a narrow range from 41 to 42 per cent per cent of GDP over the forecast period to 2012-13. The ratio of spending to GDP was expected to be flat over the first two years of the forecast, with cash spending and nominal GDP both set to rise by 10 per cent between 2007-08 and 2009-10. These forecasts incorporated the plans for Departmental Expenditure Limits (DELs) announced in the 2007 Comprehensive Spending Review (CSR) the previous autumn.
- 5.2 Table 5.1 shows the Budget 2008 forecast for different components of spending. This was only published to 2010-11 at the time. In this paper, we present the Annually Managed Expenditure (AME) forecasts out to 2012-13. (They were produced for Budget 2008 but not published.) We have then backed out the implied overall DEL levels for the two years beyond the CSR, consistent with the AME forecasts and the forecast for total spending. This is consistent with the way in which we now present public spending forecasts.
- 5.3 In a number of places in this chapter, we have had to extend the detailed assumptions underpinning the Budget 2008 forecast – for example, the caseloads underpinning welfare spending – to cover 2011-12 and 2012-13. As the Budget 2008 forecast assumed that economic activity would remain very close to its sustainable potential level in those years, we have used simple straight-line assumptions in most of the cases where the original forecasts are not available. (For example, working-age benefits caseloads are assumed to rise in line with the Budget 2008 forecast for the working-age population.)
- 5.4 It is clear from the table that not only was total spending expected to remain in a very narrow range as a share of GDP, but so too were the main components. The forecast anticipated no significant compositional shift between spending on public services, welfare spending, debt interest spending and other AME.

Table 5.1: Budget 2008 spending forecast

	£ billion						
	Outturn	Estimate	Forecast				
	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Resource Departmental Expenditure Limits	291.2	313.2	324.3	338.7	354.6	369.4	386.6
Resource Annually Managed Expenditure	215.9	227.0	242.0	253.6	267.7	280.6	293.1
<i>of which:</i>							
Social security benefits	131.3	138.5	146.4	153.7	159.7	167.0	174.6
Tax credits	16.3	17.1	19.0	20.0	20.5	21.1	21.7
Public service pensions	1.2	2.3	2.9	3.6	4.0	4.1	4.2
Locally-financed expenditure	23.4	24.7	25.7	26.7	27.8	29.1	30.3
Central government gross debt interest	27.6	29.9	30.3	30.3	34.0	35.8	37.4
Fees associated with financial interventions	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	16.0	14.4	17.8	19.3	21.8	23.6	24.8
Public sector current expenditure	507.0	540.1	566.2	592.3	622.4	650.0	679.6
Capital Departmental Expenditure Limits	38.9	43.9	48.1	50.7	55.3	54.5	58.6
Capital Annually Managed Expenditure	3.8	2.3	3.4	3.5	2.1	5.7	5.6
<i>of which:</i>							
Locally-financed expenditure	4.7	4.2	4.6	4.0	3.4	3.1	2.8
PC own-financed capital expenditure	5.4	4.7	5.2	5.6	5.7	6.5	6.9
Capital grants related to banks	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	-6.3	-6.6	-6.3	-6.1	-6.9	-4.0	-4.1
Public sector gross investment	42.7	46.2	51.5	54.3	57.4	60.2	64.2
less public sector depreciation	-16.9	-17.7	-18.6	-19.6	-20.7	-21.8	-23.0
Public sector net investment	25.8	28.5	32.9	34.7	36.7	38.4	41.2
Total Managed Expenditure	549.8	586.4	617.8	646.5	679.8	710.2	743.8
<i>of which:</i>							
Departmental Expenditure Limits	320.1	345.3	360.9	377.8	397.5	411.0	431.5
Annually Managed Expenditure	229.7	241.1	256.9	268.7	282.3	299.2	312.3
	Per cent of GDP						
Total Managed Expenditure	41.5	41.7	41.9	41.7	41.6	41.3	41.1
Departmental Expenditure Limits	24.2	24.6	24.5	24.4	24.4	23.9	23.8
Annually Managed Expenditure	17.3	17.2	17.4	17.3	17.3	17.4	17.2
<i>of which:</i>							
Social security and tax credits	11.1	11.1	11.2	11.2	11.0	10.9	10.8
Debt interest	2.1	2.1	2.1	2.0	2.1	2.1	2.1
Other AME spending	4.1	3.9	4.2	4.2	4.2	4.4	4.3

Spending during the crisis

5.5 Rather than remaining flat as a share of GDP, as forecast, Total Managed Expenditure (TME) rose by 6.5 per cent of GDP between 2007-08 and 2009-10, an unprecedented peacetime rise over just two years. Rather than increasing by 10 per cent in both cases, spending rose by around 15 per cent in cash terms, while nominal GDP fell by 1.1 per cent.

5.6 Table 5.2 compares the Budget 2008 forecasts for the change in cash spending and the change in spending as a share of GDP between 2007-08 and 2009-10 with the latest outturns. The shortfall in nominal GDP growth explains most of the change in spending as a share of GDP. The increase in cash spending was bigger than expected because:

- the forecast assumed that departments would spend right up to the limits that the Treasury had given them in 2007-08, but (as usual) there was some shortfall;
- the Government deliberately increased DELs for 2009-10 in the 2008 Pre-Budget Report and Budget 2009, in part by bringing forward planned capital spending and increasing funding for the Department for Work and Pensions (DWP);
- welfare spending was pushed higher by the downturn in the economy, which increased unemployment, and by policy measures, such as above-inflation increases in pension credit and other one-off payments to pensioners; and
- other AME spending was higher than expected, largely reflecting the fact that, when the Government paid more for shares in RBS and Lloyds in 2008 and 2009 than their market value at the time, the ONS treated the difference as a capital grant.

Table 5.2: Public spending during the crisis: 2007-08 to 2009-10

	Nominal per cent change		Change in share of GDP	
	Budget 2008	Outturn	Budget 2008	Outturn
Total Managed Expenditure	10.3	14.7	0.0	6.5
Departmental Expenditure Limits	9.4	12.6	-0.2	3.3
of which: Resource	8.2	10.4	-0.4	2.5
Capital	15.5	29.6	0.1	0.9
Annually Managed Expenditure	11.4	17.6	0.2	3.2
of which: Social security and tax credits	11.6	19.7	0.1	2.3
Debt interest	1.3	1.0	-0.2	0.0
Other AME	16.5	20.7	0.2	0.9
<i>Memo: Nominal GDP</i>	<i>10.3</i>	<i>-1.1</i>		

Budget 2008 forecast errors for spending

5.7 Total spending (TME) was around £27 billion higher in 2009-10 than expected in the Budget 2008 forecast. Table 5.3 shows the latest outturns to 2012-13 based on the then definition of DEL and AME.¹ Table 5.4 shows the differences from the Budget 2008 forecast.

¹ Latest outturns for DEL and AME have been adjusted to remove the effects of changes introduced after Budget 2008 for both 'Clear Line of Sight' and the changeover from the COINS to OSCAR public spending databases.

Table 5.3: Budget 2008 spending forecast: outturns

	£ billion						
	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Resource Departmental Expenditure Limits	291.1	309.9	320.9	342.2	354.9	349.8	348.9
Resource Annually Managed Expenditure	217.3	227.6	247.1	262.9	280.3	294.2	307.3
<i>of which:</i>							
Social security benefits	131.3	138.8	149.9	163.8	169.5	175.6	183.8
Tax credits	16.3	17.3	20.0	22.9	24.0	25.8	27.2
Public service pensions	1.0	2.2	3.1	3.7	4.5	6.7	8.5
Locally-financed expenditure	23.4	24.3	27.0	25.8	23.0	22.2	23.5
Central government gross debt interest	27.7	30.2	30.9	30.5	45.2	48.4	47.5
Fees associated with financial interventions	0.0	0.0	-1.0	-2.5	-2.4	-2.0	-0.6
Other	17.5	14.8	17.2	18.6	16.7	17.5	17.5
Public sector current expenditure	508.4	537.5	567.9	605.0	635.3	644.0	656.2
Capital Departmental Expenditure Limits	39.4	43.9	48.2	56.9	49.8	42.2	39.0
Capital Annually Managed Expenditure	6.0	5.7	19.5	11.5	9.6	8.5	7.0
<i>of which:</i>							
Locally-financed expenditure	2.8	1.6	7.2	4.9	5.4	8.4	6.5
PC own-financed capital expenditure	6.1	7.1	9.2	8.2	9.3	7.0	7.1
Capital grants related to banks	0.0	0.0	9.4	4.5	0.0	0.0	0.0
Other	-2.9	-3.0	-6.3	-6.1	-5.1	-6.8	-6.6
Public sector gross investment	45.4	49.6	67.7	68.4	59.4	50.7	45.9
less public sector depreciation	-17.4	-18.2	-19.1	-20.0	-20.8	-21.6	-22.5
Public sector net investment	28.0	31.4	48.5	48.4	38.7	29.0	23.4
Total Managed Expenditure	553.8	587.1	635.6	673.4	694.7	694.7	702.2
<i>of which:</i>							
Departmental Expenditure Limits	320.1	342.9	357.4	386.1	388.4	375.4	370.7
Annually Managed Expenditure	233.6	244.2	278.2	287.3	306.3	319.3	331.5
	Per cent of GDP						
Total Managed Expenditure	40.4	40.6	44.1	47.0	46.2	44.9	44.8
Departmental Expenditure Limits	23.4	23.7	24.8	27.0	25.9	24.3	23.7
Annually Managed Expenditure	17.1	16.9	19.3	20.1	20.4	20.6	21.2
<i>of which:</i>							
Social security and tax credits	10.8	10.8	11.8	13.0	12.9	13.0	13.5
Debt interest	2.0	2.1	2.1	2.1	3.0	3.1	3.0
Other AME spending	4.3	4.0	5.4	4.9	4.5	4.5	4.7

Table 5.4: Budget 2008 spending forecast: differences from forecast

	£ billion						
	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Resource Departmental Expenditure Limits	-0.1	-3.2	-3.4	3.4	0.3	-19.6	-37.7
Resource Annually Managed Expenditure	1.4	0.6	5.1	9.3	12.6	13.6	14.3
<i>of which:</i>							
Social security benefits	0.0	0.3	3.6	10.1	9.8	8.6	9.2
Tax credits	0.0	0.1	1.1	3.0	3.5	4.7	5.5
Public service pensions	-0.2	-0.1	0.2	0.1	0.5	2.6	4.3
Locally-financed expenditure	0.0	-0.4	1.3	-0.9	-4.8	-6.9	-6.9
Central government gross debt interest	0.1	0.2	0.6	0.1	11.2	12.6	10.1
Fees associated with financial interventions	0.0	0.0	-1.0	-2.5	-2.4	-2.0	-0.6
Other	1.5	0.5	-0.6	-0.7	-5.1	-6.0	-7.3
Public sector current expenditure	1.3	-2.6	1.7	12.7	12.9	-6.0	-23.4
Capital Departmental Expenditure Limits	0.5	0.0	0.1	6.1	-5.5	-12.4	-19.6
Capital Annually Managed Expenditure	2.2	3.4	16.1	8.0	7.5	2.9	1.3
<i>of which:</i>							
Locally-financed expenditure	-1.9	-2.5	2.6	0.9	2.1	5.3	3.6
PC own-financed capital expenditure	0.8	2.4	4.1	2.6	3.6	0.4	0.2
Capital grants related to banks	0.0	0.0	9.4	4.5	0.0	0.0	0.0
Other	3.4	3.5	0.0	0.0	1.8	-2.9	-2.5
Public sector gross investment	2.7	3.4	16.2	14.1	2.0	-9.5	-18.2
less public sector depreciation	-0.4	-0.5	-0.6	-0.4	-0.1	0.2	0.4
Public sector net investment	2.2	2.9	15.6	13.7	2.0	-9.3	-17.8
Total Managed Expenditure	4.0	0.8	17.9	26.9	14.9	-15.5	-41.7
<i>of which:</i>							
Departmental Expenditure Limits	0.0	-2.4	-3.4	8.3	-9.1	-35.6	-60.8
Annually Managed Expenditure	4.0	3.1	21.3	18.6	24.0	20.0	19.2
	Per cent of GDP						
Total Managed Expenditure	-1.1	-1.2	2.1	5.3	4.6	3.6	3.8
Departmental Expenditure Limits	-0.8	-0.9	0.3	2.6	1.5	0.4	-0.2
Annually Managed Expenditure	-0.3	-0.3	1.9	2.7	3.1	3.2	3.9
<i>of which:</i>							
Social security and tax credits	-0.4	-0.3	0.6	1.8	1.8	2.1	2.6
Debt interest	-0.1	0.0	0.1	0.2	0.9	1.0	1.0
Other AME spending	0.1	0.1	1.2	0.7	0.3	0.1	0.3

5.8 As the tables show, higher AME spending was the main reason for the overshoot in cash spending during the crisis – in particular spending on social security and tax credits. In addition, the purchase of RBS and Lloyds shares raised AME spending by £9 billion in 2008-09. Further increases in AME from equity purchases in 2009-10 were partly offset by fees from the public sector banks, which score as negative spending in the National Accounts. Errors in forecasting debt interest were negligible over this period, with higher than expected debt interest payments only materialising from 2010-11 onwards.

5.9 The Government announced several spending policy measures to help bolster economic activity. The 2008 Pre-Budget Report brought forward £3 billion of capital spending from 2010-11 to 2008-09 and 2009-10. Budget 2009 increased the DEL reserve, the Strategic Investment Fund, employment funding for DWP and support for housing supply. Of the £27

billion overshoot in total spending in 2009-10, around £11 billion was the result of policy. Table 5.5 shows that in the absence of policy measures, departmental spending would have been lower than the Budget 2008 projections in each of the three CSR years.

- 5.10 Beyond the CSR, the key rows in Table 5.5 are the changes to AME spending, where non-policy changes rise from the CSR years to £30 billion in 2012-13 and are partly offset by Coalition policy measures to reduce welfare spending, and the overall change to TME, which was largely driven by changes to the overall spending growth assumption and rises to £42 billion in 2012-13. Given higher than expected AME spending – even after the estimated effect of policy measures – and a smaller overall TME envelope, the difference between total DEL spending implied by the Budget 2008 forecast and the outturn reached £61 billion in 2012-13.

Table 5.5: Budget 2008 forecast errors: policy decisions and other factors

	£ billion					
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Total Managed Expenditure	1	18	27	15	-16	-42
of which: Policy	0	3	11	-4	-15	-42
Other	1	15	16	19	-1	0
Departmental Expenditure Limits	-2	-3	8	-9	-36	-61
of which: Policy	0	2	10	-6	n/a	n/a
Other	-2	-5	-1	-3	n/a	n/a
Annually Managed Expenditure	3	21	19	24	20	19
of which: Policy	0	1	2	2	-3	-11
Other	3	20	17	22	23	30

Spending from 2010-11

- 5.11 Total spending peaked at 47.0 per cent of GDP in 2009-10. By 2012-13, the ratio had fallen to 44.8 per cent. (As we discuss in Chapter 6, we now expect it to fall to 37.8 per cent by 2018-19.) In cash terms, TME was lower in 2012-13 than forecast in Budget 2008, with the squeeze in DEL spending offsetting higher AME spending.
- 5.12 By 2012-13, DEL spending had already fully reversed its rise during the crisis as a share of GDP, more than explaining the decline in total spending as a share of GDP. The fiscal consolidation put in place by the Labour Government from 2010-11 onwards, and then augmented by the Coalition, was the main driver. Cuts in capital DEL were particularly severe over this period, even after allowing for the fact that the limit on capital spending in 2009-10 had been boosted by bringing forward potential spending from future years.
- 5.13 An additional factor that was material in explaining lower spending in 2012-13 was departmental underspending against plans, an issue we have given greater focus since our December 2012 forecast due to the incentives facing both the Treasury and spending departments. The underspend was particularly large in 2012-13, partly because spending was subject to a severe squeeze late in the financial year to ensure that the overall budget deficit would fall in cash terms year on year. Central government departments underspent

against their plans set out in HM Treasury's Public Expenditure Statistical Analyses (PESA) 2012 publication by £8.5 billion for current spending in Resource DEL and £1.6 billion for capital spending in Capital DEL.²

- 5.14 In contrast, AME spending continued to rise as a share of GDP from 2009-10 to 2012-13, for two main reasons. First, large budget deficits and higher-than-expected RPI inflation started to push up debt interest payments. Second, social security and tax credit bills picked up significantly in 2012-13, when most social security benefits were uprated in line with the relatively high 5.2 per cent CPI inflation rate recorded in the previous September. (Welfare spending is now expected to fall as a share of GDP from 2013-14 onwards, as uprating becomes less generous and as caseloads sensitive to the ups and downs of the economic cycle fall.)

Table 5.6: Spending after the crisis: 2009-10 to 2012-13

	Nominal per cent change		Change in share of GDP	
	Budget 2008	Outturn	Budget 2008	Outturn
Total Managed Expenditure	15.1	4.3	-0.6	-2.3
Departmental Expenditure Limits	14.2	-4.0	-0.5	-3.4
of which: Resource	14.1	2.0	-0.5	-1.7
Capital	15.4	-31.5	0.0	-1.5
Annually Managed Expenditure	16.2	15.4	-0.1	1.0
of which: Social security and tax credits	13.0	13.0	-0.4	0.4
Debt interest	23.4	56.0	0.1	0.9
Other AME	21.4	4.2	0.2	-0.2
<i>Memo: Nominal GDP</i>	<i>16.7</i>	<i>7.9</i>		

Box 5.1: Public spending in recent recessions

Total public spending rose further as a share of GDP in the latest recession than it did in the recessions of the early 1980s and early 1990s, even though it increased by less in cash terms. This is because nominal GDP fell in the latest recession, but continued to rise in the previous two.

Table A: Growth in spending in the last three recessions

	1979-80 to 1981-82		1990-91 to 1992-93		2007-08 to 2009-10	
	Change in % of GDP	Nominal change	Change in % of GDP	Nominal change	Change in % of GDP	Nominal change
TME growth	3.1	34	4.0	21	6.5	15
Government consumption growth	2.0	38	1.1	15	2.4	10
Net social benefits growth	1.9	49	3.1	42	2.3	19
Proxy for AME growth	2.8	49	2.0	23	2.4	15
Net investment growth ¹	-1.3	-44	0.5	49	0.9	40

¹ Excludes capital grants to banks in the latest recession

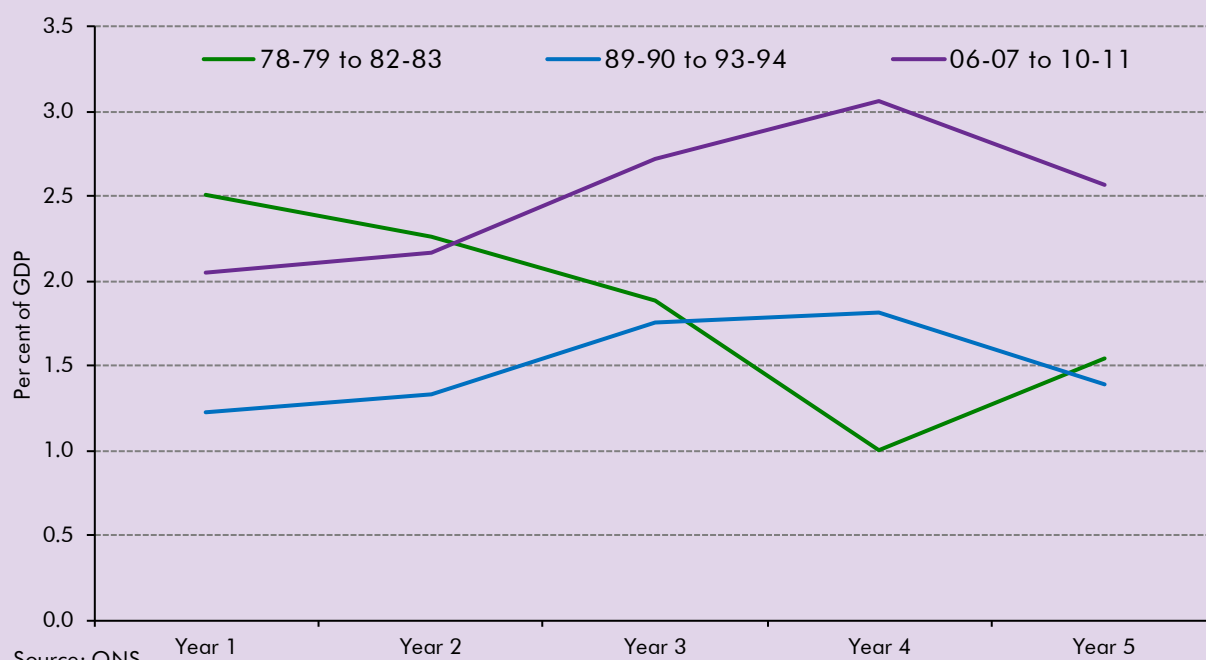
Cash spending on net social benefits (a slightly broader measure of welfare spending than we use in our forecast, covering also public service pensions, that is available over a longer time

² There was also an additional £1.5 billion underspend against the plans for Single Use Military Expenditure in Capital DEL, where this spending is currently classified as current spending in the National Accounts.

period) increased much more in the recessions of the early 1980s and 1990s than in the recent recession. This happened partly because of sharper increases in unemployment and in the number of people on incapacity benefits, and partly because of higher rates of inflation. Spending on net social benefits increased in cash terms by 49 and 42 per cent in the early 1980s and early 1990s recessions respectively, compared to just 20 per cent in the latest recession.

The 1980s recession preceded the privatisation of a number of large state-owned industries, so the Government also had more scope to cut public sector capital spending, with net investment falling by 1.3 per cent of GDP over the two-year period. In the recent recession, capital spending increased by 40 per cent in cash terms (as planned spending was brought forward to support the economy) and by 0.9 per cent of GDP to 3.1 per cent of GDP.^a

Chart A: Public sector net investment through past recessions



Source: ONS

^a These figures for the increase in capital spending exclude the capital grants related to the Government's purchase of shares in RBS and Lloyds.

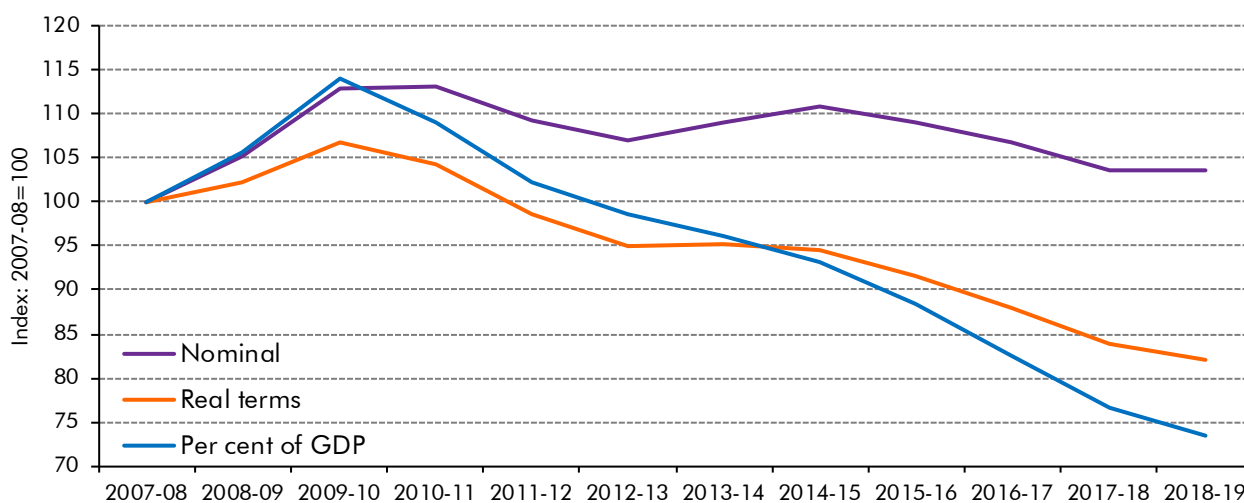
Departmental spending on public services and capital

5.15 The 2007 Comprehensive Spending Review (CSR) set out departmental limits for spending on public services, administration and capital investment (DELs) for 2008-09 to 2010-11. The forecasts for these areas of spending in Budget 2008 were almost identical to the limits set in the CSR. DELs were expected to be almost flat as a share of GDP over the CSR period.

Departmental spending through the crisis

5.16 In the event departmental spending was not constant as a share of GDP between 2007-08 and 2009-10, but rose by 3.3 per cent of GDP.³ Cash spending increased more than forecast, reflecting policy increases in the DEL limits after the CSR as part of the fiscal stimulus, which were partly offset by subsequent underspends. More importantly, the limits were not reduced in line with the shortfall in nominal GDP relative to the Budget 2008 forecast.

Chart 5.1: Departmental spending on public services and capital (TME in DEL)¹



¹ TME in DEL is the definition of total DEL used in OBR forecasts since Budget 2011. It includes all spending in total DEL (Resource DEL and Capital DEL) that is included in TME.

² The figures for TME in DEL shown here are taken from Chart 4.3 in our March 2014 EFO, adjusted from 2013-14 onwards to exclude grants for council tax benefit and include grants for business rates retained by local authorities. These adjustments make these later DEL data comparable with the outturn DEL data for the years before 2013-14.

Source: HMTreasury, ONS, OBR

5.17 Three-year fixed cash limits for departmental spending were set out for the first time in the 1998 CSR. By preventing departments from re-negotiating their spending settlements every year, one hope was that this would help restrain spending and borrowing as a share of GDP in the event of higher than expected inflation. But in an environment in which whole economy inflation and nominal GDP were much weaker than expected, the opposite was true. The 2007 limits were largely adhered to, but the unexpected weakness of nominal GDP (and therefore tax receipts) made them less affordable.

5.18 In cash terms, growth in DEL spending over this period was more modest both in plans and outturns than in any of the previous three Spending Review periods. Chart 5.2 shows the real and nominal growth in government consumption plus investment, a National Accounts measure that is broadly equivalent to DEL plus equivalent locally financed spending.

³ Departmental spending measured as TME in total DEL. See the notes on the DEL data in Chart 5.1 above.

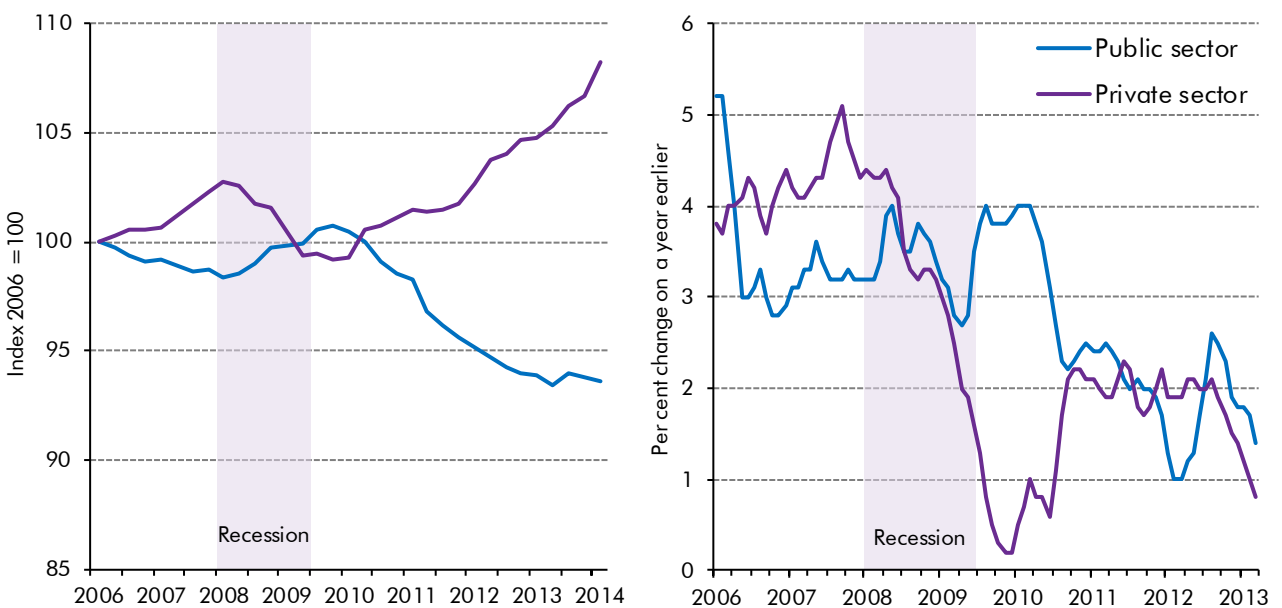
Chart 5.2: Growth in government consumption and investment



Source: ONS

5.19 Sticking to the 2007 CSR plans helped support the economy during the downturn, although this could presumably have been achieved in other ways. Chart 5.3 shows that public sector earnings growth and employment were both maintained at pre-crisis levels through the downturn, while private sector pay growth and employment fell sharply. This reversed once the fiscal consolidation began. Government consumption and investment grew by 4.8 per cent in real terms over the two years to 2009-10. This contributed 1.1 percentage points to real GDP growth, despite which GDP fell 6.4 per cent overall.

Chart 5.3: Employment and earnings growth: public and private sectors



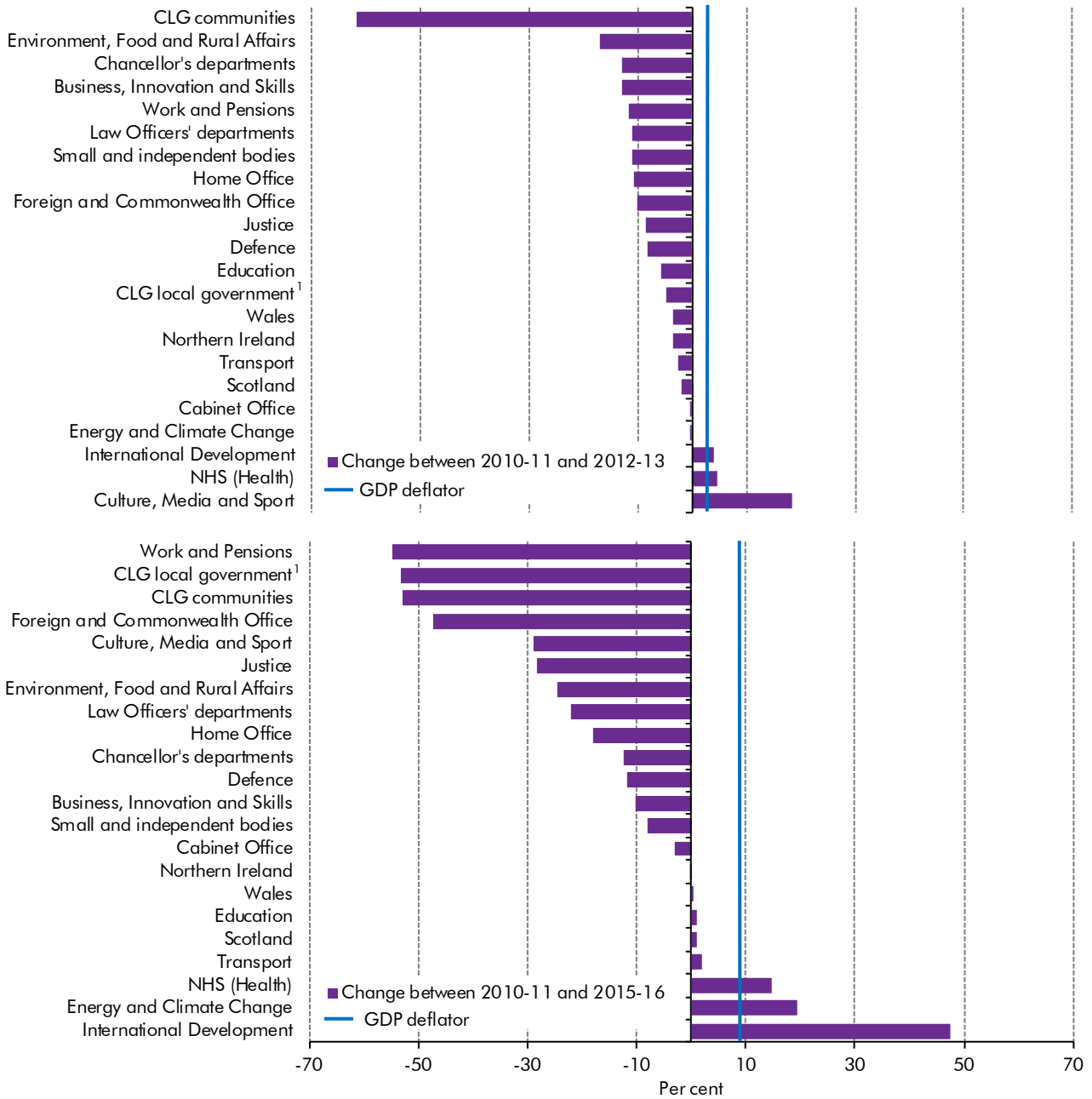
Note: adjusted for reclassifications.
Source: ONS

Source: ONS

Departmental spending under Spending Review 2010

- 5.20 As potential output was revised down, as described in Chapter 3, an increasing proportion of the prospective shortfall in tax receipts relative to the Budget 2008 forecast was judged to be permanent, rendering the spending plans from CSR 2007 unaffordable. The Labour Government started to address this by cutting public investment sharply and slowing the assumed growth of current (non-investment) spending. The Coalition Government increased and accelerated the pace of the current spending cuts, including by announcing a £6 billion in-year reduction in 2010-11 spending limits immediately after taking office.
- 5.21 Chart 5.4 below shows the outturn reduction in nominal total DEL between 2010-11 and 2012-13 and then the reduction up to 2015-16, the final year for which we have detailed spending plans. These figures are taken from HM Treasury's PESA 2014 publication and 2010-11 therefore represents outturn rather than the baseline against which the SR was conducted. In both comparisons, the difference between 'protected' areas such as health, education and international development and other areas is stark. (Two departments that appear to counter that trend are DCMS in the period to 2012-13, which largely reflects temporary spending related to the Olympics, and DECC in the period to 2015-16, which is related in part to the package of energy-related policy measures announced by the Government in Autumn Statement 2013.)

Chart 5.4: Change in total Departmental Expenditure Limits by departmental group



¹The increase between 2010-11 and 2015-16 reflects changes to local government funding in 2013-14 for the localisation of business rates and council tax benefit. Figures for all years include grants for personal social services (Health) previously paid by the Department of Health.

Source: HM Treasury

Welfare spending

5.22 Budget 2008 predicted that welfare spending⁴ (by which we mean here spending on social security and tax credits) would fall slightly as a per cent of GDP between 2007-08 and 2012-13. In the event, welfare spending rose by 2.3 per cent of GDP during the crisis and then by a further 0.2 per cent of GDP between 2009-10 and 2012-13. The continued rise reflected higher than expected inflation in both 2011-12 and 2012-13.

5.23 Reforms to welfare (particularly uprating most benefits in line with CPI rather than RPI inflation), and a cyclical recovery reducing caseloads relative to the population, are now expected to reduce spending by 1.7 per cent of GDP by 2018-19, compared to 2012-13. This still leaves welfare spending in 2018-19 around 0.8 per cent of GDP higher than its pre-crisis level in 2007-08. This remaining difference can be fully accounted for by higher spending on state pensions (which have been uprated according to the 'triple lock' since 2011-12), although there are other offsetting upward and downward pressures. Over the whole period from 2007-08 to 2018-19, welfare spending is forecast to rise by over 50 per cent in cash terms and by around 20 per cent in real terms.

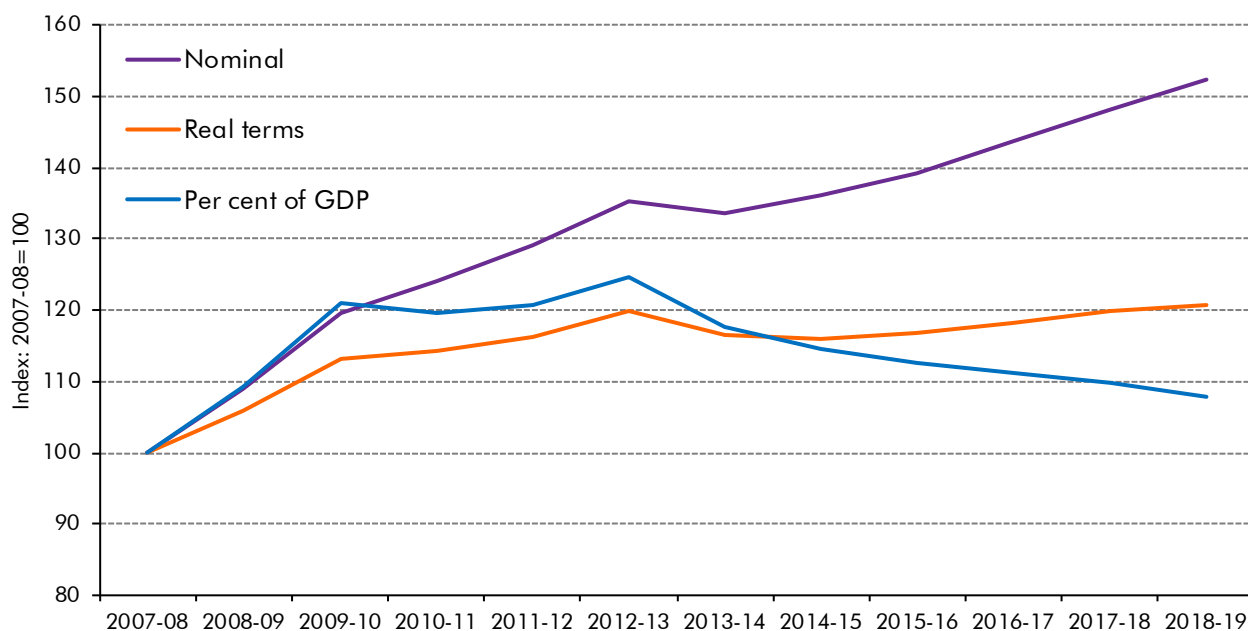
Table 5.7: Changes in welfare spending

	Change in spending as a share of GDP			
	Change between 2007-08 and 2018-19	Change between 2007-08 and 2009-10	Change between 2009-10 and 2012-13	Change between 2012-13 and 2018-19
Social security and tax credits¹	0.8	2.3	0.2	-1.7
<i>of which:</i>				
Tax credits	0.1	0.5	-0.1	-0.3
Child benefit	-0.1	0.1	-0.1	-0.2
State pension	0.9	0.7	0.4	-0.2
Housing benefit	0.3	0.3	0.1	-0.2
JSA	0.0	0.2	0.0	-0.2
Income support	-0.5	0.0	-0.2	-0.2
DLA/PIP	0.0	0.1	0.1	-0.2
Incapacity benefit/ESA	0.2	0.1	0.1	0.1
Winter fuel payments	0.0	0.0	-0.1	0.0
Pension credit	-0.2	0.1	-0.1	-0.2
Other social security	0.1	0.3	0.0	-0.2
<i>Memo: Tax credits (AME)</i>	<i>0.4</i>	<i>0.4</i>	<i>0.1</i>	<i>-0.1</i>
<i>Memo: Tax credits (negative tax element)</i>	<i>-0.3</i>	<i>0.1</i>	<i>-0.2</i>	<i>-0.2</i>

¹Excludes council tax benefit and includes tax credits (AME) and tax credits (negative tax element) in order to be consistent with spending definitions by the end of the forecast period (2018-19).

⁴ In order to be consistent with spending definitions by the end of the forecast period (2018-19) we are excluding council tax benefit from social security which was transferred to departmental expenditure limits from 2013-14 and including the negative tax element of universal credit which is being transferred into tax credits AME spend with the migration of claimants over to universal credit by the end of the forecast period

Chart 5.5: Welfare spending



Source: HM Treasury, ONS

5.24 Table 5.8 shows the Budget 2008 forecast errors on components of welfare spending. Welfare spending was running almost £13 billion higher than forecast by 2009-10, with the scale of that overshoot being reined in very modestly over the subsequent three years. The majority of the total error was accounted for by four items – housing benefit, tax credits, state pensions and unemployment benefits – which are discussed in more detail below.

Table 5.8: Budget 2008 forecast errors for welfare

	£ billion					
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Social security and tax credits¹	0.1	4.9	12.9	12.9	12.2	11.8
of which:						
Tax credits	-0.1	1.4	3.1	3.5	3.8	2.7
State pension	0.2	0.3	1.7	1.7	2.5	3.9
Pension credit	0.0	0.2	0.4	0.2	-0.3	-0.9
Housing benefit	0.5	1.0	2.9	3.5	3.9	4.1
JSA	0.0	0.5	1.8	1.3	1.4	1.3
DLA	0.0	0.0	0.3	0.2	0.2	0.4
Incapacity benefit/ESA	0.1	0.0	0.3	0.0	-0.1	0.9
Winter fuel payments	0.0	0.0	0.6	0.6	0.0	0.0
Other social security ²	-0.7	1.4	1.9	1.8	0.8	-0.6
<i>Memo: Tax credits (AME)</i>	0.1	1.1	3.0	3.5	4.7	5.5
<i>Memo: Tax credits (negative tax element)</i>	-0.2	0.4	0.2	0.0	-0.9	-2.8

¹ Excludes council tax benefit and includes tax credits (AME) and tax credits (negative tax element) in order to be consistent with spending definitions by the end of the forecast period (2018-19).

² Other social security includes child benefit, income support and other smaller benefits.

5.25 The factors behind the errors in Table 5.8 can be related to:

- caseloads (Table 5.9): the downturn caused a sharp and unexpected rise in the number of people receiving income-related benefits, such as jobseekers allowance (JSA) and housing benefit. (In contrast, caseloads for state pensions were close to expectations); and

Table 5.9: Caseloads compared with Budget 2008 forecasts

	Thousands					
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
State pension	-23	-42	-42	-58	-186	-276
Housing benefit	21	165	557	833	943	1041
JSA	66	270	636	440	534	520
DLA	15	24	40	33	62	97
IB/ESA	15	148	213	258	227	156
	Per cent					
State pension	-0.2	-0.3	-0.3	-0.5	-1.4	-2.1
Housing benefit	0.5	4.1	14.0	21.0	23.7	25.9
JSA	8.8	35.8	70.5	45.1	54.5	52.7
DLA	0.5	0.8	1.3	1.0	1.9	3.0
IB/ESA	0.6	6.4	9.6	12.0	10.5	7.2

- relative generosity (Table 5.10): the rise in the cash value of most individual benefit payments was larger than forecast, reflecting uprating in line with higher-than-expected inflation and policy decisions (e.g. the Labour Government's decision to increase the child tax element of tax credits well above inflation and Coalition Government's introduction of the triple lock for the basic state pension).

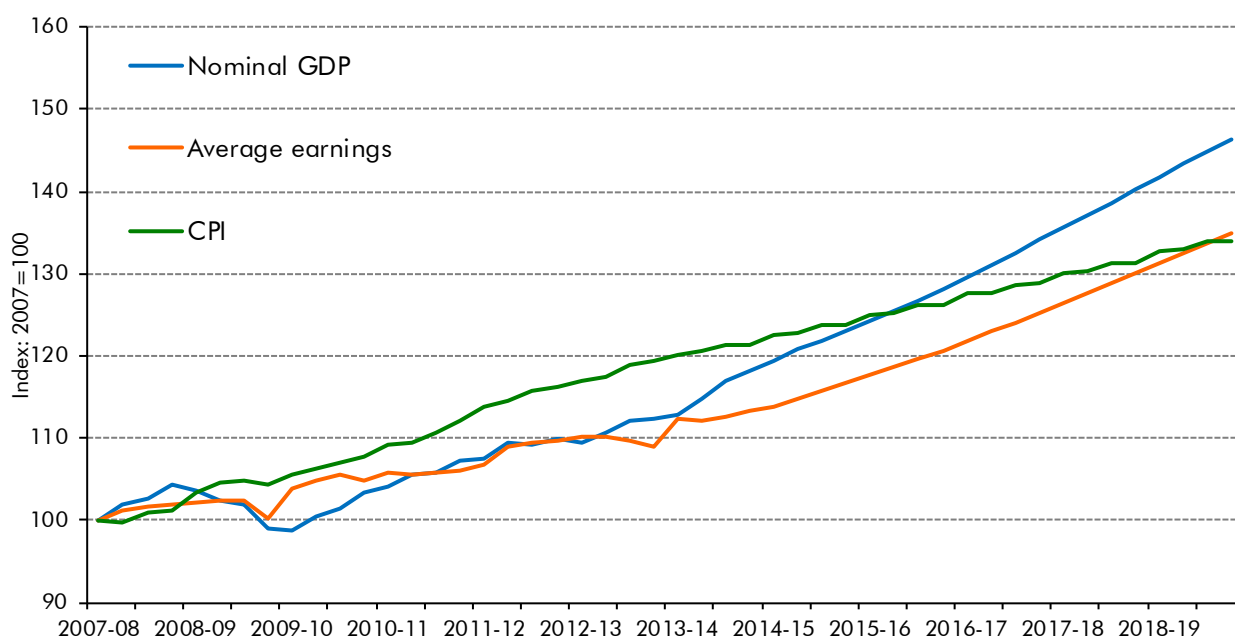
Table 5.10: Relative generosity of selected benefits

	Relative to CPI inflation since 2007-08		
	2010-11	2012-13	2018-19
Basic state pension	1.4	4.2	10.5
JSA rate for single, childless person, aged 25+	0.3	1.6	-1.7
Housing benefit average award	3.8	2.7	1.7
Child tax credit, child element rate	13.0	23.4	20.3
	Relative to average earnings growth since 2007-08		
Basic state pension	5.7	12.1	10.8
JSA rate for single, childless person, aged 25+	4.5	9.3	-1.5
Housing benefit average award	8.2	10.5	1.9
Child tax credit, child element rate	17.8	32.8	20.6

5.26 When discussing the 'generosity' of changes in the value of individual benefit payments, different benchmarks can be used. For the purposes of policy discussion and analysing movements in welfare spending, three are perhaps particularly relevant (Chart 5.6): consumer prices (what recipients can buy with them), average earnings (the wages and salaries of people in work) and nominal GDP (the cash size of the economy that will have to finance them). As the chart shows, between early 2007-08 and the end of 2012-13,

average earnings increased by about 9 per cent while consumer prices increased by 19 per cent – a fall in real wages on this measure of 8 per cent. Our March 2014 forecast suggests that average earnings will now grow more rapidly than prices on average, returning real earnings to roughly their pre-crisis level in by the end of 2018, by which point both consumer prices and average earnings will have increased by about 34 per cent since early 2007. Meanwhile nominal GDP moved broadly in line with average earnings until 2013 and is now expected to grow more rapidly than either prices or earnings, reflecting rising employment, the weakness of wages relative to productivity in the near term and, in the case of prices, our assumption that real earnings and productivity will pick up over the forecast period. By early 2019, nominal GDP is forecast to be around 50 per cent higher than it was in early 2007. This implies that if a particular benefit rose in line with inflation throughout this period – and there was no change in caseload – then the cost of the benefit would have risen as a share of GDP from 2007 to 2013 (in other words throughout the Budget 2008 forecasting period), returned to its starting point by 2015, and then fallen below it thereafter.

Chart 5.6: Benchmarks for benefit generosity



Source: ONS, OBR

State pensions

5.27 The increase in spending on state pensions since 2007-08, relative to the Budget 2008 forecast, primarily reflects the substantial rise in the value of the average pension relative to all the benchmarks set out above. The state pension has consistently been uprated by more than average earnings growth and frequently by more than inflation, for example by 2.5 per cent in 2010 (when RPI inflation the previous September had been negative) and then in line with the ‘triple lock’ since 2011. This effect on cash spending was particularly big in 2012-13 when pensions were uprated by 5.2 per cent, reflecting September 2011 inflation, while average earnings grew by just 1.0 per cent. By 2012-13 the value of the state pension

had been increased by almost 4 per cent relative to inflation, 12 per cent relative to average earnings and almost 11 per cent relative to nominal GDP since 2007-08.

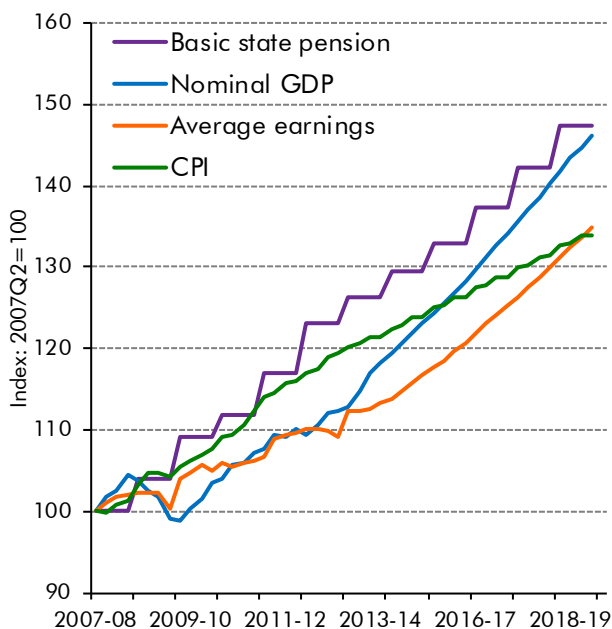
5.28 By contrast, caseloads for the state pension were close to expectations, since these are dominated by relatively predictable demographic trends.

5.29 Under the terms of the triple lock, our forecast implies that the value of the state pension will rise by slightly more than average earnings in 2014-15 and in line thereafter, thus falling slightly relative to nominal GDP. By 2018-19 state pension spending is forecast to be 0.9 per cent of GDP higher than it was in 2007-08 and 1.2 per cent of GDP higher than if it had been raised consistently with either average earnings or consumer prices since then.

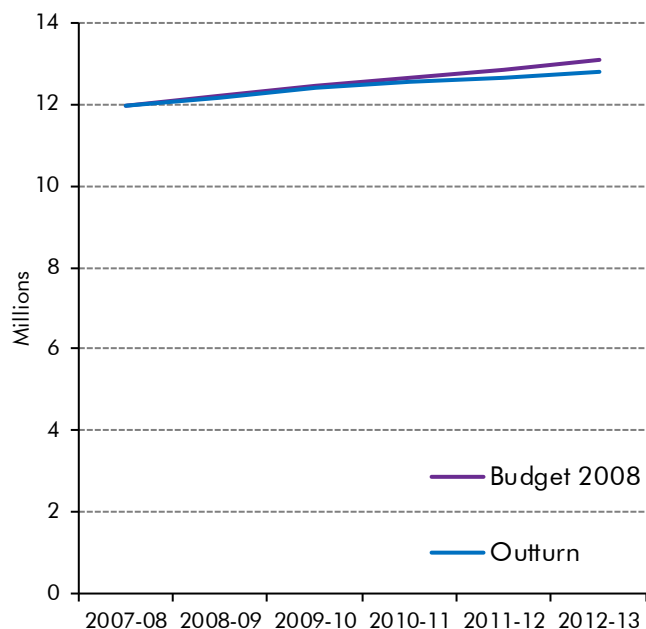
Table 5.11: State pension spending compared with Budget 2008 forecasts

	£ billion					
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Budget 2008 forecast	57.4	61.3	65.2	68.1	71.6	76.0
Outturn	57.6	61.6	66.9	69.8	74.2	79.8
Forecast error	0.2	0.3	1.7	1.7	2.5	3.9
of which:						
Change in caseload	-0.1	-0.2	-0.2	-0.3	-1.0	-1.6
Change in generosity	0.3	0.5	1.9	2.0	3.5	5.4

Chart 5.7: Relative generosity of basic state pension and changes in caseload from Budget 2008 forecast



Source: DWP, ONS, OBR



Source: DWP, OBR

Jobseekers' allowance

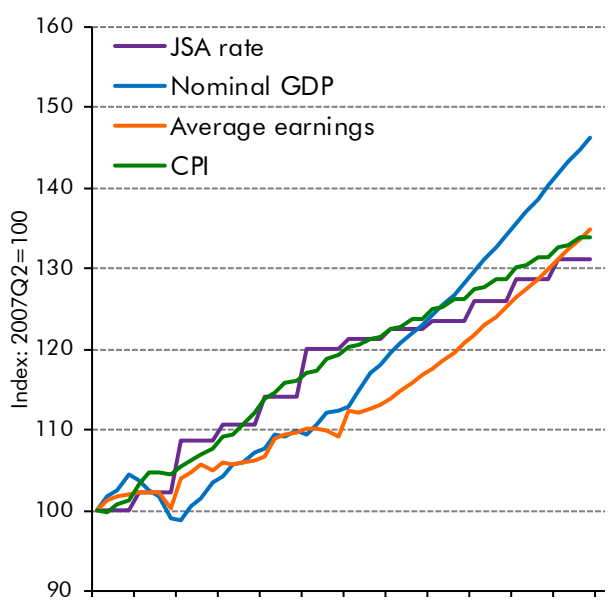
5.30 The higher spending on JSA mainly reflects the rise in the caseload resulting from the increase in unemployment during the downturn. As noted earlier, the rise in unemployment was less than would have been expected on the basis of previous recessions. The caseload for JSA has also been boosted by the lone parent obligation (LPO) moving people from income support to JSA. By the end of 2012-13, there were around 150,000 more lone parents on JSA than there were prior to the LPO being introduced.

5.31 By 2012-13 the value of the JSA rate⁵ had risen by 2 per cent relative to inflation and 9 per cent relative to average earnings, compared to 2007-08. On current policy the JSA rate will fall back to its pre-crisis value in real terms by 2015-16 and will remain there thereafter. By 2018 the value of JSA will also therefore have fallen back to its pre-crisis value relative to average earnings, but will be below its pre-crisis value relative to nominal GDP.

Table 5.12: JSA spending compared with Budget 2008 forecasts

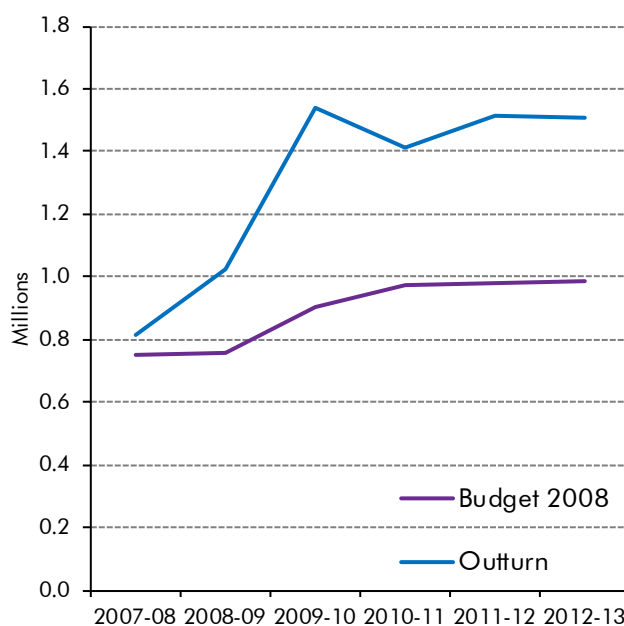
	£ billion					
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Budget 2008 forecast	2.2	2.3	2.9	3.1	3.6	3.8
Outturn	2.2	2.9	4.7	4.5	4.9	5.2
Forecast error	0.0	0.5	1.8	1.3	1.4	1.3
of which:						
Change in caseload	0.2	0.3	1.9	1.4	1.7	1.7
Change in generosity	-0.1	0.3	-0.1	-0.1	-0.3	-0.4

Chart 5.8: Relative generosity of JSA and changes in caseload from Budget 2008 forecast



JSA rate for single, childless person, over 25.

Source: DWP, ONS, OBR



Source: DWP

⁵ JSA rate for single, childless person, over 25

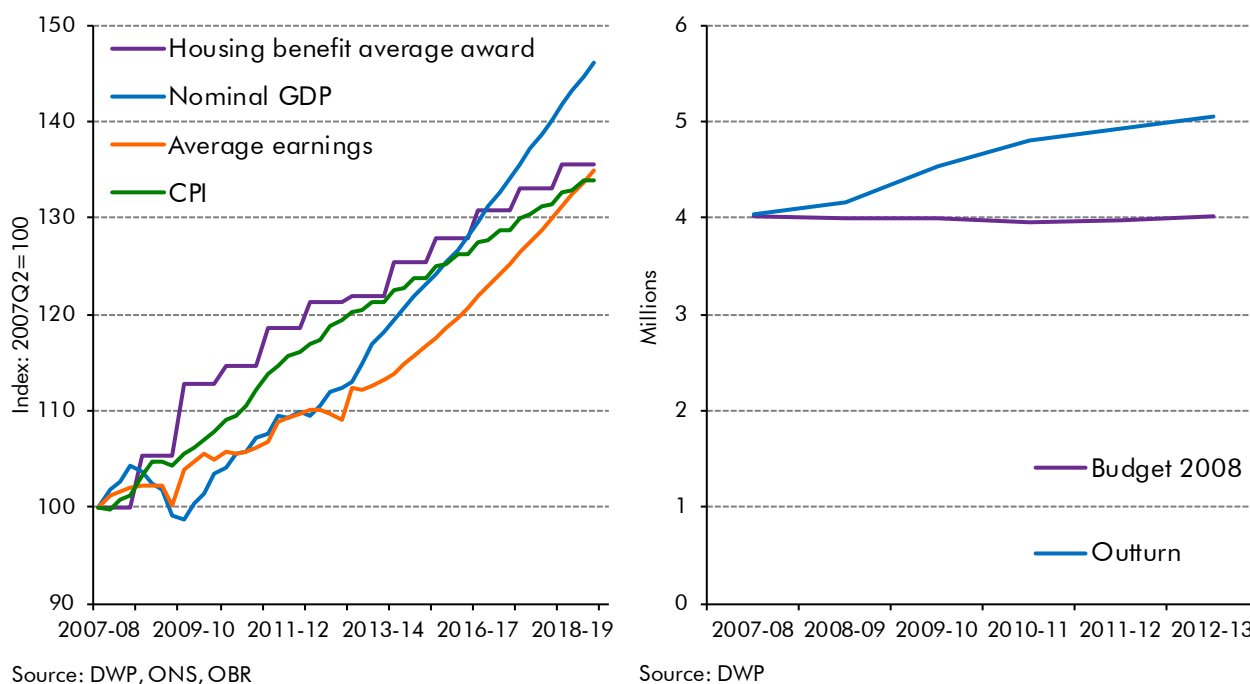
Housing benefit

- 5.32 Housing benefit was one of the largest errors in the Budget 2008 welfare spending forecast, with spending underestimated by £4.1 billion or roughly 20 per cent by 2012-13. This was more than accounted for by a higher than forecast caseload. The overshoot on caseloads was more than 800,000 (21 per cent) by 2010-11 and more than a million (26 per cent) against our extension of the Budget 2008 forecast by 2012-13.
- 5.33 In part, this reflected a rise in the number of people on JSA and claiming housing benefit, but in-work cases rose even more steeply. Depressed earnings growth and more part-time work led to an increase in the number of employed people eligible for housing benefit. The increase in in-work cases may also have been the result of more movements in and out of employment, bringing a higher proportion of people in work into the benefit system at some point. Alongside these cyclical effects on the caseload, there has been an upward trend in claims related to the shift from owner-occupation to renting since around 2004-05, which was exacerbated by the effect of the crisis on mortgage availability for first-time buyers.
- 5.34 By 2012-13, the value of housing benefit per recipient had risen by 3 per cent relative to inflation and 11 per cent relative to average earnings, compared to 2007-08. This reflects compositional changes with much of the rise in caseload since 2007-08 being in the private rental sector, where awards are higher, as well as depressed average earnings growth. Increases in eligible rents above inflation also explain this increased 'generosity' up to 2009-10, although recent policy reforms in the private rental sector have acted to constrain rental growth in this sector.

Table 5.13: Housing benefit spending compared with Budget 2008 forecasts

	£ billion					
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Budget 2008 forecast	15.2	16.1	17.1	17.9	18.9	19.8
Outturn	15.7	17.1	20.0	21.4	22.8	23.9
Forecast error	0.5	1.0	2.9	3.5	3.9	4.1
<i>of which:</i>						
Change in caseload	0.1	0.7	2.4	3.7	4.4	4.9
Change in generosity	0.4	0.3	0.4	-0.2	-0.5	-0.8

Chart 5.9: Relative generosity of housing benefit and changes in caseload from Budget 2008 forecast



Source: DWP, ONS, OBR

Source: DWP

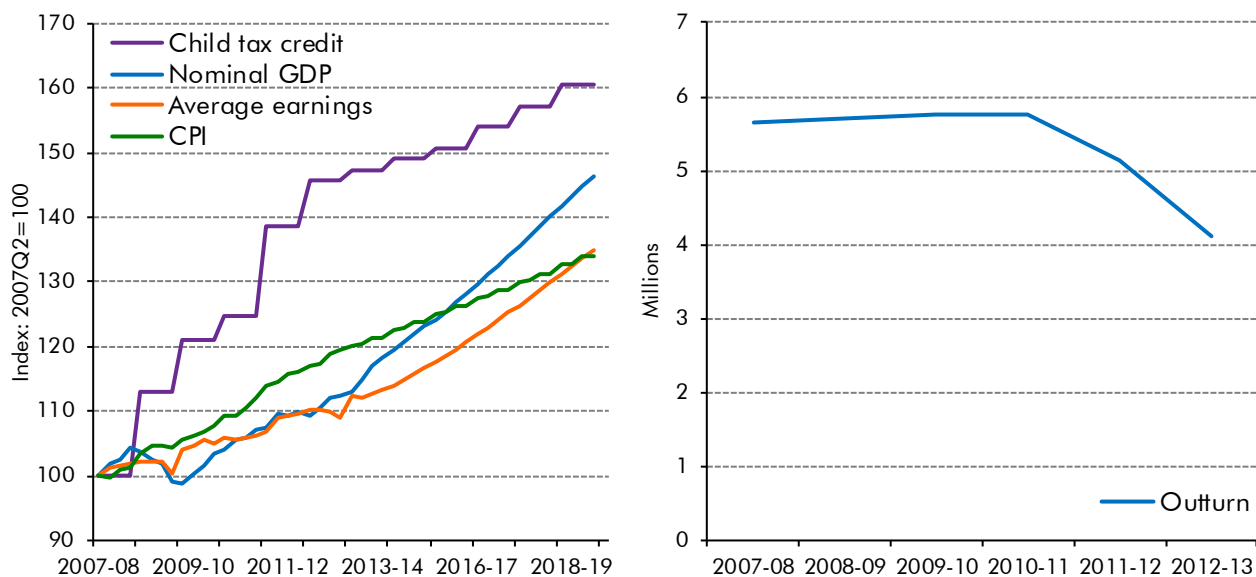
Tax credits

5.35 The rise in tax credits spending as a share of GDP during the downturn reflects both the relative generosity of tax credits and a rise in caseloads. The Labour Government raised the value of the child tax credit by substantially more than inflation several years running. By 2012-13, the value of child tax credits had risen by 23 per cent relative to consumer prices and by 33 per cent relative to average earnings since 2007-08. The uprating slowed thereafter and by 2018-19 the increases in generosity relative to consumer prices and earnings are expected to be down to 20 and 21 per cent respectively since 2007-08. Tax credit generosity will still be higher relative to nominal GDP than it was prior to the crisis.

5.36 Meanwhile, the total tax credit caseload rose by around 300,000 between the start of 2007-08 and 2009-10. Depressed wage growth and the increase in part-time work made more people eligible for tax credits and increased entitlements for some existing recipients.

5.37 Caseloads fall markedly from 2011-12 following the June 2010 Budget decisions first to lower the second income threshold from £50,000 to £40,000 in 2011-12, and then to taper the family element immediately after the child element in 2012-13. This removed a large number of higher-income families on low awards.

Chart 5.10: Relative generosity of child tax credit and caseload outturn



Child tax credit represents the child element rate.
Source: DWP, ONS, OBR

Child tax credit caseload forecasts not available.
Child tax credit outturn represents any family benefiting from the child elements of child tax credits.
Source: HMRC

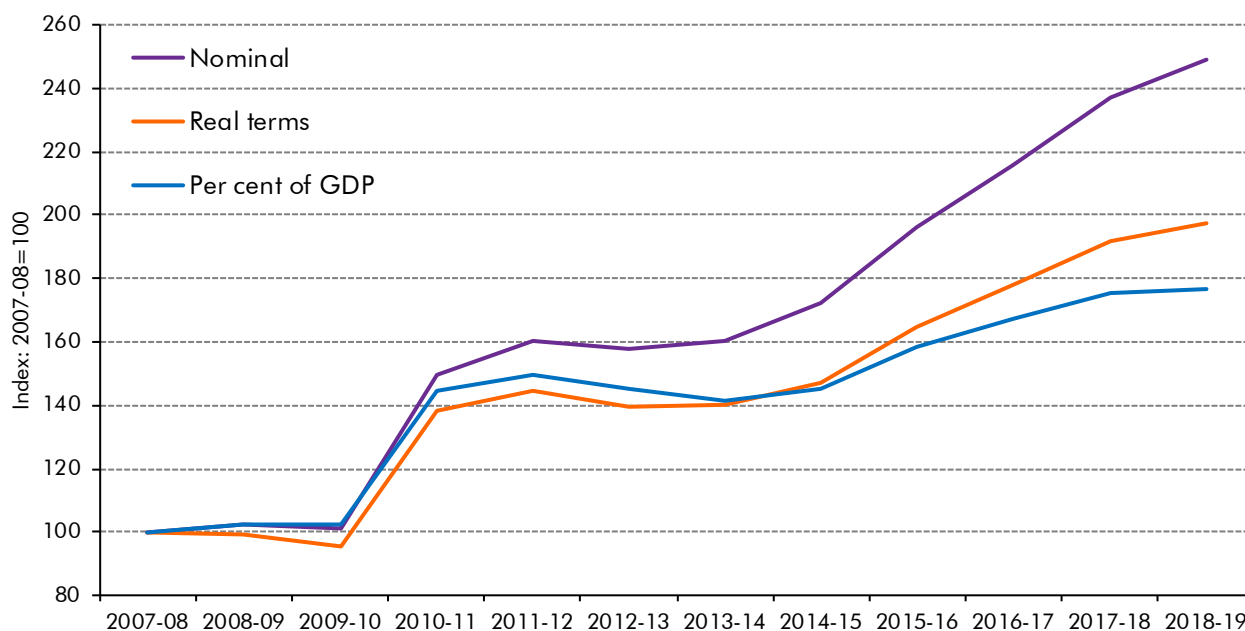
Summary

- 5.38** Welfare spending increased sharply as a share of GDP during the crisis and the period of slow recovery that followed. That reflected increases in caseloads related to the economic downturn, overlaid by other long-term trends in caseloads, plus the effect of inflation uprating and the shortfall in nominal GDP.
- 5.39** We forecast that welfare spending will fall as a share of GDP over the next five years, as uprating becomes less generous for most benefits. But it will remain above its pre-crisis level partly due to some persistent trends in caseloads (e.g. the effect on housing benefit of more people renting than owning their homes) but in particular due to the combined effect of demographic trends and the triple lock on cost of state pensions.

Debt interest

- 5.40** Debt interest payments were expected to remain at close to their post-war low of 2.1 per cent of GDP throughout the Budget 2008 forecast. By 2012-13, debt interest payments had risen to 3.0 per cent of GDP and our latest forecast shows a further rise to 3.7 per cent of GDP by 2018-19.
- 5.41** Of the major spending components, debt interest payments show the strongest total increase between 2007-08 and 2018-19. Chart 5.10 shows that payments are expected to rise by around 150 per cent in cash terms and almost double in real terms over that period.

Chart 5.11: Debt interest spending



Source: ONS, OBR

5.42 By 2012-13, debt interest payments were just over £10 billion higher than the Budget 2008 forecast at £47.5 billion. This reflected higher cumulative government borrowing and higher RPI inflation from 2010-11 onwards, partly offset by lower interest rates. Table 5.14 uses a ready-reckoner consistent with the Budget 2008 forecasting model to break down the error.

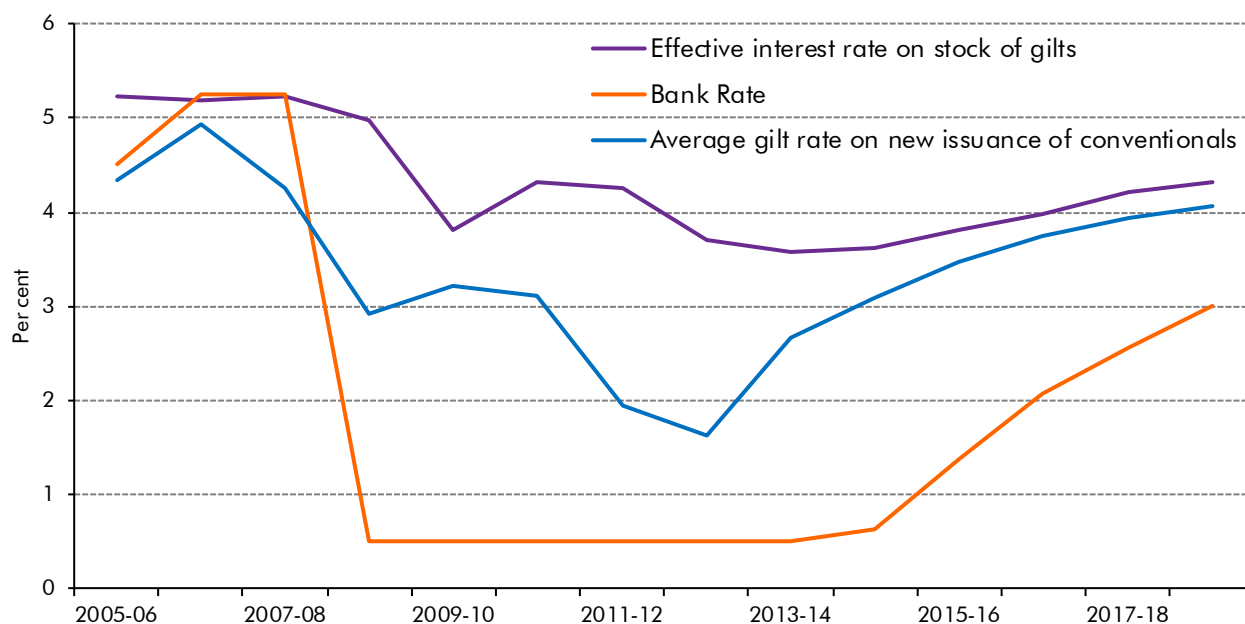
5.43 Cumulative cash borrowing (as measured by the central government net cash requirement, rather than public sector net borrowing as shown in Chapter 3) was over £510 billion higher than forecast by 2012-13. This on its own would have implied debt interest payments £23 billion higher than forecast in Budget 2008.

Table 5.14: Explaining the forecast error for debt interest payments

	£ billion					
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Budget 2008	29.9	30.3	30.3	34.0	35.8	37.4
Outturn	30.2	30.9	30.5	45.2	48.4	47.5
Difference	0.2	0.6	0.1	11.2	12.6	10.1
<i>by component:</i>						
Debt interest on conventional gilts	0.5	0.5	4.5	8.2	9.5	9.3
Debt interest on index-linked gilts	0.0	0.1	-0.1	-0.2	-0.2	-0.4
Accrued uplift on index-linked gilts	0.0	0.1	-2.6	4.3	4.3	2.9
Other	-0.2	0.0	-1.7	-1.1	-1.0	-1.6
<i>by factor:</i>						
Higher cash borrowing	0.0	2.9	9.2	15.0	19.5	23.4
RPI inflation	0.0	0.0	-2.1	3.9	3.9	1.0
Interest rates	-0.1	-0.7	-4.6	-6.1	-7.6	-12.1
Other	0.3	-1.7	-2.4	-1.6	-3.2	-2.2

- 5.44 Debt interest payments were pushed a further £1 billion above forecast in 2012-13 by slightly higher-than-expected inflation in 2012, via its effect on the accrued uplift on index-linked gilts. (The upward pressure on interest payments had been more marked in the previous two years, reflecting much higher inflation than expected, having been downward in 2009-10 after RPI temporarily turned negative in 2009.) The path of the accrued uplift helps to explain the path of debt interest payments in cash terms during the recession. Debt interest payments were essentially flat between 2007-08 and 2009-10 before rising sharply in 2010-11. The accrued uplift on index-linked gilts fell from £4.6 billion in 2008-09 to £1.2 billion in 2009-10 and then rose to £9.6 billion for the next two years.
- 5.45 Lower interest rates have partially offset the effect of higher government borrowing. Bank Rate was quickly reduced to 0.5 per cent while the average gilt rate on new conventional issuance fell from 4.7 per cent in 2007-08 to 1.6 per cent in 2012-13. The real interest rate on index-linked gilts also fell over the same period from 1.5 per cent to -0.6 per cent.
- 5.46 Given the long average maturity for conventional gilts, lower interest rates only reduce debt interest payments with a lag. Payments on the existing stock of conventional gilts are fixed for the lifetime of those gilts. Chart 5.12 shows that the effective interest rate on the stock of gilts fell more slowly than the average gilt rate on new conventional issuance between 2007-08 and 2012-13. Likewise, as bond yields are assumed to rise over the period to 2018-19, the effective rate on the stock of gilts picks up later and at a slower rate.

Chart 5.12: Effective interest rate on the stock of conventional gilts



Source: Bank of England, OBR

Other Annually Managed Expenditure

- 5.47 Annually Managed Expenditure (AME) also includes a variety of other items, other than the welfare spending and debt interest already discussed above. Tables 5.15 and 5.16 show the main components of the other AME spending. The largest other AME spending item is locally-financed expenditure. Other large AME items include net public service pensions, net expenditure transfers to the EU, spending related to environmental levies, public corporations' capital expenditure, and the National Accounts measures of depreciation and VAT refunds. Other smaller items include spending by the National Lottery and the BBC.
- 5.48 Table 5.16 shows that other AME spending – that is, total AME spending in TME, other than spending on welfare and debt interest – rose by 0.9 per cent of GDP between 2007-08 and 2009-10. This compared with the Budget 2008 forecast of a rise of 0.1 per cent of GDP. As with DEL spending, much of the rise in the ratio of other AME spending to GDP during the crisis period reflected the fall in nominal GDP. However cash spending was also a little higher than forecast, reflecting the capital grants related to the failed banks and the fact that locally-financed expenditure was boosted by lower asset sales, which are treated as negative spending. The weakness of asset sales in part reflected difficult credit conditions and reduced right-to-buy sales to tenants affected by the recession.

Table 5.15: Other AME spending (£ billion)

	£ billion			
	2007-08	2009-10	2012-13	2018-19
Other AME ^{1,2}	70.6	83.3	90.3	113.9
of which:				
Locally-financed expenditure ²	26.0	30.7	29.3	36.8
Net public service pensions	2.2	3.7	8.5	12.6
Capital grants to failed banks	0.0	4.5	0.0	0.0
Fees related to financial interventions	0.0	-2.5	-0.6	0.0
Net expenditure transfers to EU	5.5	5.7	8.3	7.9
Spending related to environmental levies	0.9	1.1	1.7	8.3
Public corporations capital expenditure	8.0	9.2	7.2	6.4
Depreciation	13.4	14.9	17.3	22.0
Other ³	14.6	16.0	18.5	19.8

¹ Other AME is total AME (Resource AME and Capital AME) that is included in TME, other than welfare spending and debt interest (as shown in Table 5.7 and Chart 5.11). The figures for total TME in AME are taken from Chart 4.3 in our March 2014 EFO.

² These figures have been adjusted to exclude business rates retained by local authorities (from 2013-14 onwards), so that the spending is comparable over the whole period.

³ Other spending in other AME includes grants from the National Lottery, spending by the BBC, and various adjustments to include additional items that are classified as spending in the National Accounts, including VAT refunds.

Table 5.16: Other AME spending (per cent of GDP)

	Per cent of GDP			
	2007-08	2009-10	2012-13	2018-19
Other AME ^{1,2}	4.9	5.8	5.4	5.6
of which:				
Locally-financed expenditure ²	1.8	2.1	1.9	1.8
Net public service pensions	0.2	0.3	0.4	0.6
Capital grants to failed banks	0.0	0.3	0.0	0.0
Fees related to financial interventions	0.0	-0.2	-0.1	0.0
Net expenditure transfers to EU	0.4	0.4	0.4	0.4
Spending related to environmental levies	0.1	0.1	0.1	0.4
Public corporations capital expenditure	0.6	0.6	0.5	0.3
Depreciation	0.9	1.0	1.0	1.0
Other ³	1.0	1.2	1.1	1.0

¹ Other AME is total AME (Resource AME and Capital AME) that is included in TME, other than welfare spending and debt interest (as shown in Table 5.7 and Chart 5.11). The figures for total TME in AME are taken from Chart 4.3 in our March 2014 EFO.

² These figures have been adjusted to exclude business rates retained by local authorities (from 2013-14 onwards), so that the spending is comparable over the whole period.

³ Other spending in other AME includes grants from the National Lottery, spending by the BBC, and various adjustments to include additional items that are classified as spending in the National Accounts, including VAT refunds.

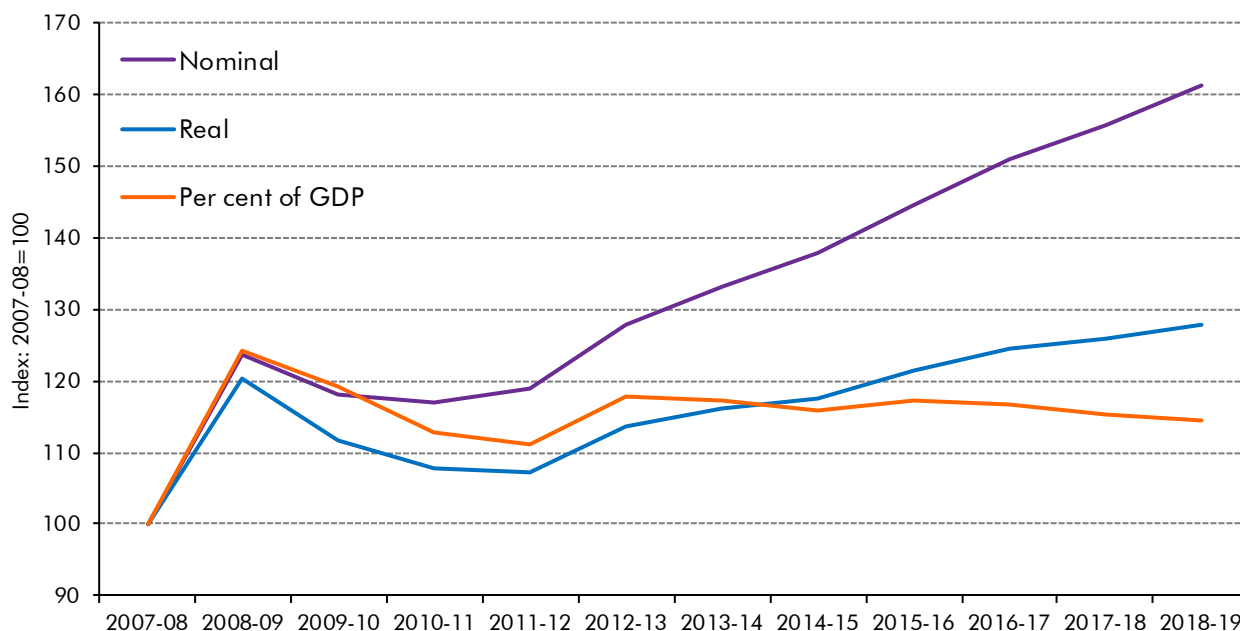
5.49 Other AME spending rose 0.9 per cent of GDP above its pre-crisis level by 2009-10, falling back to an increase of 0.5 per cent of GDP by 2012-13. Our latest forecast suggests that it will remain at 0.7 per cent of GDP above its pre-crisis level by 2018-19. This persistent increase can be explained by the increases in spending on net public service pensions and spending funded by environmental levies:

- net public service pension payments (i.e. benefits paid less employee and employer contributions received) rose from 0.2 per cent of GDP to 0.4 per cent of GDP in 2012-13 and are expected to rise further to 0.6 per cent of GDP by 2018-19. Payments rose initially as a share of GDP because nominal GDP was lower than expected in the downturn, while cash payments were unaffected. Higher-than-expected inflation, particularly in September 2011, then pushed spending up further because pensions in payment are uprated with CPI inflation. Beyond 2012-13, cuts to the public sector workforce will increase net spending initially, by reducing contributions, but they will then reduce it by more over the longer term as fewer public sector workers retire; and
- spending funded by environmental levies is also expected to rise from 0.1 per cent of GDP in 2007-08 to 0.4 per cent of GDP by 2018-19. This relates to spending policies such as the Renewables Obligation, Contracts for Difference, Feed-in tariffs, Renewable Heat Initiative and Warm Homes Discount. Most of these are neutral for borrowing as they are offset by receipts of the same value.

5.50 Our latest forecast also suggests that locally-financed spending will return to its pre-crisis level of spending as a share of GDP by 2018-19. (For the purposes of comparison, this does not include spending since 2013-14 which local authorities have been able to finance from retained business rates, which were previously transferred to central government and then included in DEL grants to local authorities.) Most of the remaining locally-financed

spending is funded from council tax, and the recent freezes and caps on council tax increases have limited the scope for additional spending.

Chart 5.13: Other AME spending



Source: OBR, HM Treasury

Conclusion

- 5.51** Spending plans set out in CSR 2007 were largely adhered to during the crisis, with some capital spending brought forward from 2010-11 to 2009-10, and some additional spending in areas like employment support to help ameliorate the recession. Cash spending on welfare increased as the economy contracted.
- 5.52** Combined with the fall in nominal GDP, the ratio of total spending to GDP increased sharply between 2007-08 and 2009-10. Higher than expected inflation in 2011 then fed through to a further rise in welfare spending, especially in 2012-13.
- 5.53** As the gap between spending and receipts was increasingly judged to be structural, so the Labour and Coalition Governments aimed to reduce the deficit by cutting spending back to levels that would be affordable against lower expected receipts. That has involved sharp reductions in capital spending (announced by the Labour Government), cuts to welfare spending (announced and implemented by the Coalition Government), and – much the largest component – cuts to current spending on public services (signalled in Labour’s final budget, augmented and extended by the Coalition, and only partially delivered to date).

6 Back to balance?

6.1 In the preceding chapters, we have described how the public finances deteriorated dramatically through the crisis and have partially recovered during the initial years of the consolidation. Our latest forecast suggests that, on the basis of the Coalition Government's current policies, receipts and public spending will be restored to overall balance by 2018-19. All forecasts are subject to significant uncertainty, but if our central forecast proved to be accurate, 2018-19 would see the first budget surplus since 2000-01 and only the thirteenth since 1948. Not only would the dramatic crisis-related increase in the deficit have been reversed, but the stubborn pre-crisis deficit would also have been eliminated.

6.2 In this chapter:

- we run through the main features of our latest central forecast for the next five years, describing how the public finances get back to balance; and
- we compare our forecast for the public finances in 2018-19 with the position immediately prior to the crisis in 2007-08 and the position in 2001-02, the last time the budget was close to balance, to illustrate what will have changed in terms of spending and revenues following both the crisis and consolidation.

The next five years

6.3 As described in the preceding chapters, having risen to a post-war record of 11.0 per cent of GDP in 2009-10, public sector net borrowing fell thereafter as the economy slowly recovered and the fiscal consolidation began to be implemented. By 2012-13, the final year of the Budget 2008 forecast, the deficit stood at 7.3 per cent of GDP, down by around a third from the peak. In terms of the consolidation, the most significant policy measures over this period were the increases in the main rate of VAT from 15 per cent to 17½ per cent in January 2010 and then to 20 per cent in January 2011, and the cuts to public investment as fiscal stimulus was removed and the consolidation began.

Deficit reduction in 2013-14

6.4 Deficit reduction slowed in 2012-13 as the recovery stalled and as most social security benefits were uprated in line with the relatively high rate of inflation recorded in the previous autumn. As the economy and housing market picked up, deficit reduction gathered pace again in 2013-14 with the deficit falling to 6.6 per cent of GDP. The main contributions to deficit reduction in 2013-14 came from spending, with RDEL – current spending on public services – and social security spending each falling by around ½ per cent of GDP. But tax receipts fell relative to GDP in 2013-14. In particular, income tax receipts increased more

slowly than GDP due largely to the impact of policy changes – the raising of the personal allowance and the shifting of income into the following financial year as taxpayers sought to take advantage of the lowering the additional rate of income tax from 50p to 45p from April 2013. The latter reduced self-assessment liabilities in 2012-13, on which tax was paid in 2013-14. In contrast, capital tax receipts – in particular stamp duty land tax – increased rapidly in 2013-14 as house prices and transactions picked up.

The March 2014 Budget forecast

- 6.5 Over the five years from 2013-14 to 2018-19, our March 2014 *EFO* forecast shows the economy continuing to recover, with GDP growth at above-trend rates until the output gap closes in early 2018. As spare capacity is used up, unemployment is forecast to fall back to our estimate of its sustainable level – a little over 5 per cent – and employment to grow. Inflation is forecast to remain close to the Bank's 2 per cent target for most of the forecast period, while house price inflation is forecast to peak in 2014 and ease thereafter.
- 6.6 Against this economic backdrop – and conditioned on the Coalition Government's current tax policies, detailed spending plans to 2015-16 and total spending assumption thereafter – we expect the deficit to fall each year and the public finances to return to balance in 2018-19. Over the next five years, the majority of the deficit reduction is forecast to come from reductions in spending relative to GDP. In particular, current spending on public services (RDEL) falls from 19.2 per cent of GDP in 2013-14 to just 14.2 per cent of GDP in 2018-19. Excluding transfers to the Exchequer related to quantitative easing, receipts rise by a little over 1 per cent of GDP, mainly thanks to income tax and NICs, and capital taxes.

The economy

- 6.7 A full description of our latest medium-term economy forecast is available in Chapter 3 of our March 2014 *EFO*. As we have seen, while most economic forecasts focus on the outlook for real GDP, nominal GDP is more important for the public finances. This reflects developments in both real GDP and whole economy inflation. The composition of nominal GDP is also important for the fiscal forecast. On the income side, labour income is generally taxed more heavily than company profits. On the expenditure side, much of consumer spending is subject to VAT and other indirect taxes, while business investment attracts capital allowances that reduce corporation tax receipts in the short term. Asset and commodity markets also play an important role for the public finances.
- 6.8 The key fiscal determinants from our March 2014 forecast are set out in Table 6.1. Charts 6.1 and 6.2 show the contributions of different forms of income and expenditure to nominal GDP growth over the forecast period. In summary:
- **real and nominal GDP growth** are forecast to ease from 2014-15 into 2015-16 as consumer spending growth moves more in line with income growth. Growth picks up again as underlying productivity growth recovers. Then, once the output gap has closed in early 2018, the rate of growth reverts to its assumed trend rate;

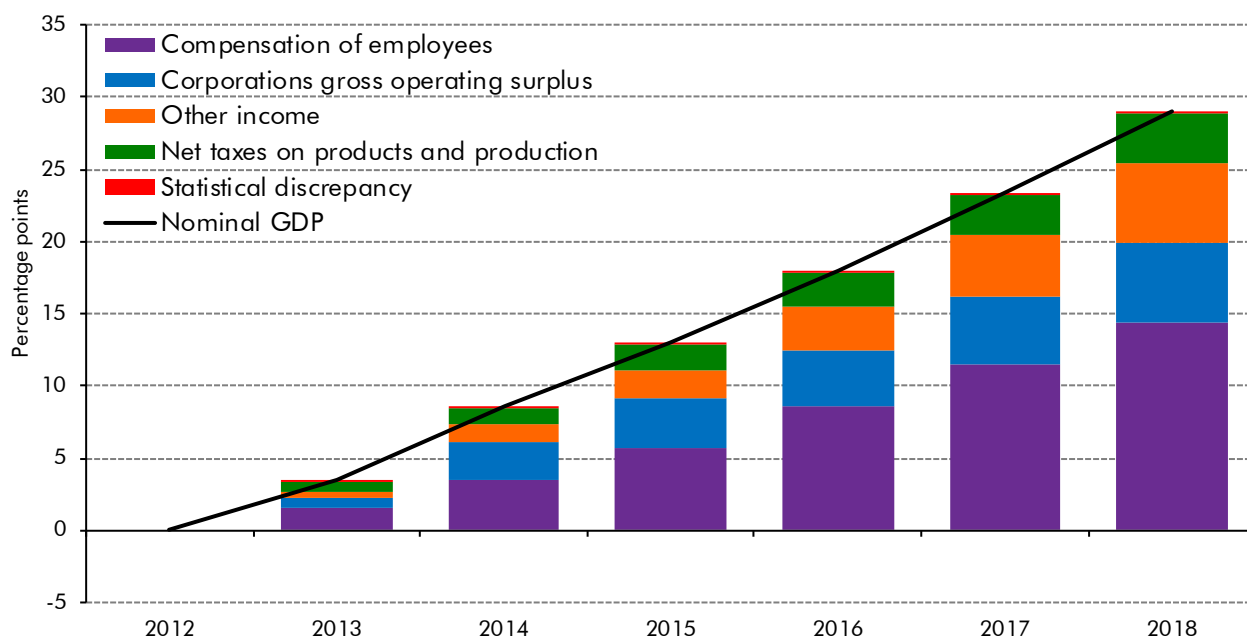
- **wages and salaries** are forecast to grow broadly in line with nominal GDP;
- **nominal consumer spending** growth averages 4.6 per cent a year between 2014-15 and 2018-19;
- non-oil non-financial **company profits** are expected to grow strongly in the near term, reflecting recent momentum, and to average growth of just over 5 per cent a year between 2015-16 and 2018-19;
- the **CPI measure of inflation**, which is used to index many tax rates, allowances and thresholds, and to uprate benefits and public sector pensions, is expected to be close to the Bank of England's target of 2 per cent throughout the forecast;
- **RPI inflation**, which determines the debt interest paid on index-linked gilts and is used to revalorise excise duties, is higher than CPI inflation in each year of the forecast, partly due to the mortgage interest payment component of RPI inflation, which is not included in CPI;
- **house prices** are forecast to rise 8.6 per cent in 2014-15, with the rate of increases easing slightly in 2015-16 – after which we assume they rise in line with earnings;
- **residential property transactions** grow strongly in 2014-15, by more than 18 per cent on the previous year, and return to a historic average relative to the housing stock by 2018-19;
- **oil prices** are assumed to move in line with futures prices over the next two years, and are then to remain flat at that level for the remainder of the forecast period. **Oil and gas production** forecasts were based on the central projection published by the Department of Energy and Climate Change (DECC); and
- **equity prices** are assumed to rise from their level at Budget time in line with our forecast for nominal GDP, while short- and long-term **interest rates** are assumed to move in line with market expectations based on forward rates.

Table 6.1: Determinants of the fiscal forecast: March 2014

	Percentage change on previous year unless otherwise specified						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
GDP and its components							
Real GDP	0.3	2.3	2.6	2.4	2.6	2.6	2.4
Nominal GDP ¹	1.4	4.7	4.6	3.9	4.6	4.5	4.4
Nominal GDP (£ billion) ^{1,2}	1571	1644	1721	1788	1871	1956	2042
Nominal GDP (centred end-March £bn) ^{1,3}	1597	1688	1754	1827	1913	1999	2088
Wages and salaries ⁴	2.4	3.9	3.5	4.2	4.7	4.6	4.4
Non-oil PNFC profits ^{4,5}	2.8	7.0	10.7	4.9	5.4	5.3	4.8
Non-oil PNFC net taxable income ^{4,5}	6.4	6.9	9.8	3.1	3.2	2.9	2.4
Consumer spending ^{4,5}	4.1	4.5	4.5	4.1	4.8	5.0	4.7
Prices and earnings							
GDP deflator	1.6	1.8	2.2	1.6	1.9	1.9	2.0
RPI (September)	2.6	3.2	2.5	3.3	3.7	3.8	3.9
CPI (September)	2.2	2.7	1.8	2.0	2.0	2.0	2.0
Average earnings ⁶	1.0	2.6	2.4	3.3	3.7	3.7	3.8
'Triple-lock' guarantee (September)	2.5	2.7	2.5	3.3	3.6	3.7	3.8
Key fiscal determinants							
Claimant count (millions)	1.57	1.35	1.18	1.11	1.04	0.97	0.94
Employment (millions)	29.6	30.0	30.4	30.7	31.0	31.2	31.4
VAT gap (per cent)	10.9	10.3	9.9	9.9	9.9	9.9	9.9
Output gap (per cent of potential output)	-2.8	-2.0	-1.3	-1.0	-0.6	-0.2	0.0
Financial and property sectors							
Equity prices (FTSE All-Share index)	3066	3498	3747	3897	4074	4260	4449
HMRC financial sector profits ^{1,5,7}	3.4	1.4	2.3	4.0	4.7	4.6	4.4
Financial sector net taxable income ^{1,5}	4.2	2.6	-0.2	3.1	7.0	3.4	3.7
Residential property prices ⁸	2.1	4.9	8.6	7.4	4.3	3.7	3.7
Residential property transactions (000s) ⁹	930	1146	1357	1407	1450	1493	1526
Commercial property prices ⁹	2.3	11.9	2.1	2.0	3.7	3.0	2.0
Commercial property transactions ⁹	1.5	9.3	3.9	3.1	3.9	4.1	3.0
Volume of stampable share transactions	-18.1	10.5	3.9	-2.6	-2.6	-2.6	-2.6
Oil and gas							
Oil prices (\$ per barrel) ⁵	112.0	108.8	107.5	102.0	99.3	99.3	99.3
Oil prices (£ per barrel) ⁵	70.6	69.6	64.7	61.1	59.2	59.0	59.1
Gas prices (p/therm) ⁵	59.1	66.9	60.2	63.2	63.2	63.2	63.2
Oil production (million tonnes) ^{5,10}	44.5	40.6	39.2	39.2	39.2	39.2	39.2
Gas production (billion therms) ^{5,10}	13.8	12.8	12.8	12.7	12.7	12.7	12.7
Interest rates and exchange rates							
Market short-term interest rates (%) ¹¹	0.7	0.5	0.6	1.3	2.0	2.6	3.1
Market gilt rates (%) ¹²	1.6	2.6	2.9	3.3	3.6	3.9	4.0
Euro/Sterling exchange rate (€/£)	1.23	1.19	1.22	1.22	1.23	1.25	1.26

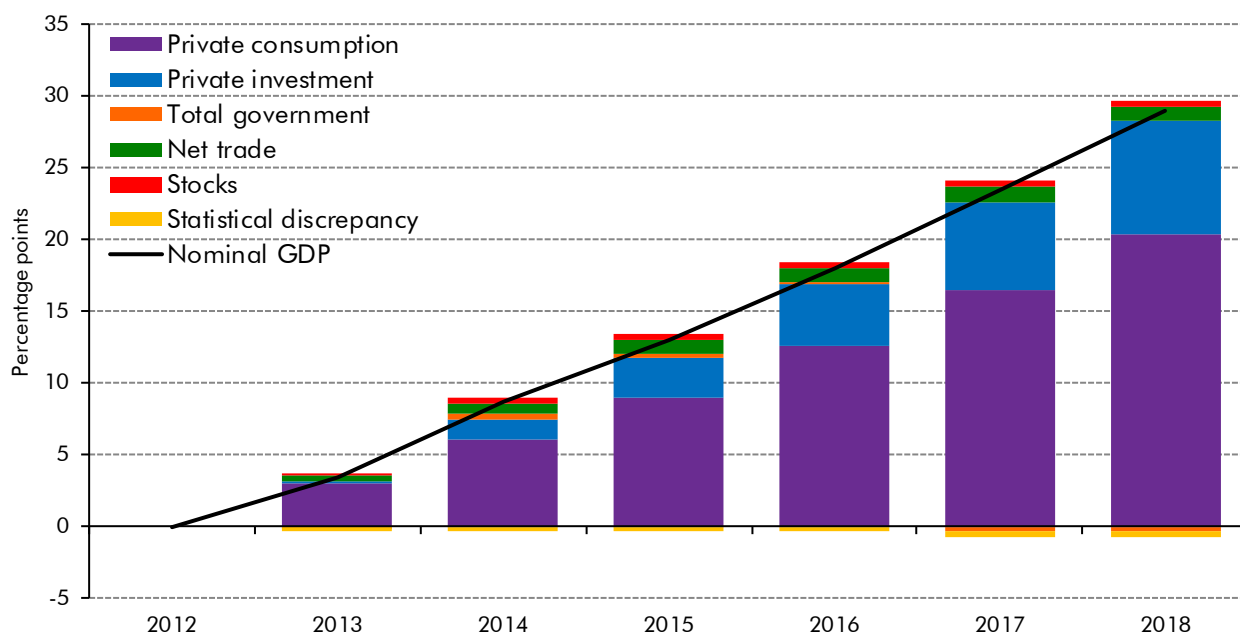
¹ Not seasonally adjusted.² Denominator for receipts, spending and deficit forecasts as a per cent of GDP.³ Denominator for net debt as a per cent of GDP.⁴ Nominal.⁵ Calendar year.⁶ Wages and salaries divided by employees.⁷ HMRC Gross Case 1 trading profits.⁸ Outturn data from ONS House Price Index.⁹ Outturn data from HMRC information on stamp duty land tax.¹⁰ Department of Energy and Climate Change (DECC) forecasts available at www.gov.uk/oil-and-gas-uk-field-data¹¹ 3-month sterling interbank rate (LIBOR).¹² Weighted average interest rate on conventional gilts.

Chart 6.1: Contributions to nominal GDP growth: income



Source: ONS, OBR

Chart 6.2: Contributions to nominal GDP growth: expenditure



Source: ONS, OBR

Receipts

6.9 Public sector current receipts are expected to fall as a share of GDP in 2013-14, mainly as a result of lower income tax and NICs receipts. This is partly due to the £1,335 rise in the personal allowance, subdued earnings growth and the deferral of income to take advantage of the reduction in the additional rate from 50p to 45p in April 2013, which reduces self-assessment receipts in 2013-14 (and will boost them in 2014-15). Lower oil

and gas revenues have also contributed to the fall. From 2014-15 onwards, current receipts are expected to rise as a share of GDP. Table 6.2 summarises our central forecast for the major taxes. Detailed forecasts are available in Chapter 4 of our March 2014 *EFO*.

Table 6.2: Major receipts as a per cent of GDP

	Per cent of GDP						
	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
Income tax and NICs	16.4	16.0	16.1	16.3	16.8	17.0	17.2
Value added tax	6.4	6.5	6.4	6.4	6.4	6.3	6.3
Onshore corporation tax	2.3	2.2	2.3	2.2	2.2	2.2	2.1
UK oil and gas receipts	0.4	0.3	0.2	0.2	0.2	0.2	0.2
Fuel duties	1.7	1.6	1.6	1.5	1.5	1.5	1.5
Business rates	1.7	1.6	1.6	1.6	1.6	1.6	1.6
Council tax	1.7	1.7	1.6	1.6	1.5	1.5	1.5
Excise duties	1.3	1.2	1.2	1.2	1.2	1.2	1.2
Capital taxes	1.0	1.2	1.5	1.6	1.7	1.7	1.8
Other taxes	2.7	2.9	2.9	2.9	2.8	2.8	2.7
National Accounts taxes	35.5	35.2	35.2	35.5	35.8	35.9	35.9
Interest and dividend receipts exc. APF	0.5	0.4	0.4	0.5	0.7	0.7	0.8
Other receipts	1.4	1.3	1.3	1.3	1.3	1.3	1.3
Current receipts exc. APF	37.4	37.0	37.0	37.4	37.8	38.0	38.1
APF dividend receipts	0.4	0.7	0.7	0.4	0.2	0.0	0.0
Current receipts	37.8	37.7	37.7	37.8	38.0	38.0	38.1

6.10 The increase in the receipts-to-GDP ratio largely comes from:

- income tax and NICs, which increase as a share of GDP over the forecast as positive fiscal drag returns. The Budget 2013 measure to abolish the NICs contracting out rebate also raises NICs by 0.3 per cent of GDP from 2016-17 onwards;
- capital taxes, including stamp duty on land and shares, capital gains tax and inheritance tax, which are forecast to rise from 1.2 per cent to 1.8 per cent of GDP between 2013-14 and 2018-19. Stamp duty land tax contributes more than half of this increase as house prices and transactions continue to rise; and
- interest and dividend receipts, excluding APF transfers, as higher interest rates are earned on a rising stock of assets.

6.11 The main offsetting falls include:

- receipts from oil and gas producers, reflecting flat production and high operating and capital expenditure in the industry, which is tax deductible;
- onshore corporation tax, reflecting policy measures that lower the main rate to 20 per cent by 2015-16;

- VAT receipts, as the share of household spending on goods and services subject to the tax falls; and
- fuel duty, reflecting policy measures that reduce real duty rates and improvements in vehicle efficiency.

Spending

- 6.12 Total public spending (TME) is forecast to fall relative to GDP in every year of the forecast period. Table 6.3 shows how TME is split between DEL and AME, and the main components of AME. Detailed spending forecasts are available in our March 2014 *EFO*.
- 6.13 AME is forecast to be relatively flat as a share of GDP over the forecast period. Social security payments are forecast to fall gradually as a share of GDP as the economy recovers and most benefits are uprated by less than earnings growth, while debt interest payments rise due to higher debt and interest rates. AME spending is expected to exceed DEL spending for the first time in 2013-14 and, as shown in Chart 6.3, by an increasing margin thereafter. This partly reflects the transfer of some spending from DEL to AME from 2013-14 onwards, reflecting local authorities' retention of business rates and the localised council tax reduction schemes.¹ But it also reflects the Government's choices in setting detailed spending plans up to 2015-16 and a TME growth assumption for the years from 2016-17.

Table 6.3: Total managed expenditure split between DEL and AME

	Per cent of GDP						
	Outturn	Forecast					
		2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Total managed expenditure	44.7	43.5	42.5	41.6	40.2	38.8	37.8
TME in DEL ^{1,2,3}	22.5	21.5	20.9	19.8	18.4	17.1	16.3
of which:							
PSCE in RDEL	20.1	19.2	18.5	17.5	16.2	14.9	14.2
PSGI in CDEL	2.0	2.0	2.2	2.1	2.0	1.9	1.9
TME in AME ⁴	22.2	22.0	21.7	21.8	21.8	21.8	21.6
of which:							
Social security ²	11.6	10.9	10.7	10.6	10.4	10.2	10.0
Debt interest	3.0	2.9	3.0	3.3	3.5	3.7	3.7
Locally-financed current expenditure ³	1.5	2.1	2.0	2.1	2.1	2.1	2.2
Other PSCE in AME	5.2	5.2	5.0	5.0	5.0	5.0	5.1
PSGI in AME ⁴	0.8	0.9	0.9	0.8	0.8	0.8	0.7

¹ In relation to Table 4.17 in the March 2014 *Economic and fiscal outlook*, TME in DEL is defined as PSCE in RDEL plus PSGI in CDEL plus SUME, and TME in AME is defined as PSCE in AME plus PSGI in AME minus SUME. SUME is single use military equipment.

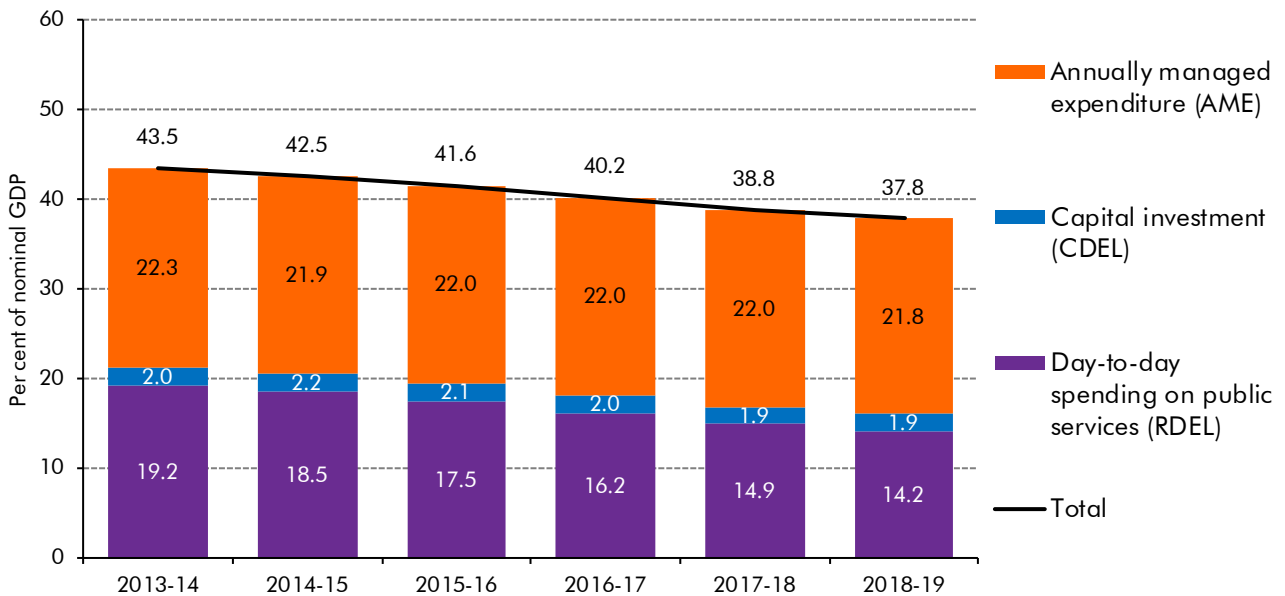
² From 2013-14, grants to local authorities in TME in RDEL were increased to cover the introduction of the localised council tax reduction schemes, and social security in TME in AME was reduced because the new localised schemes replaced council tax benefit.

³ From 2013-14, locally-financed current expenditure in TME in AME increased to include local authorities retention of business rates, and TME in RDEL was reduced because it no longer included grants to distribute these business rates to local authorities.

⁴ Excludes Royal Mail and APF spending. Royal Mail and APF spending as a percentage of GDP is shown in table 4.12 and headline TME is shown in Table 4.17 in the March 2014 *Economic and fiscal outlook*.

¹ These switches between DEL and AME were set out in Box 4.2 of the December 2012 *EFO*.

Chart 6.3: Public spending to 2018-19

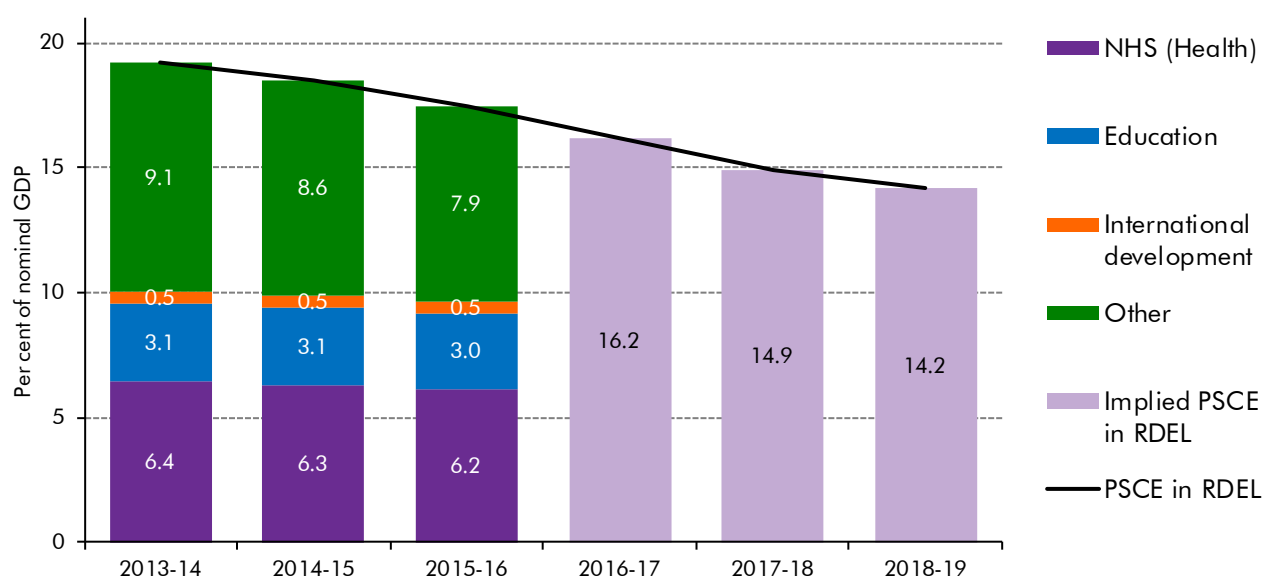


Memo: AME includes Single Use Military Equipment.
 Source: HMT, OBR

6.14 Departmental spending is set to play the largest role in reducing total public spending relative to GDP. Chart 6.4 shows the trend in RDEL as a share of GDP (specifically PSCE in RDEL², which is consistent with the National Accounts fiscal aggregates) – the proportion of national income devoted to day-to-day spending on public services and administration – mostly public sector pay and procurement. For the years where the Government has set detailed plans, the chart also shows the share of spending where the Government has further stated objectives, such as the commitment to maintain total health spending in real terms or to spend 0.7 per cent of gross national income on Official Development Assistance (some of which is capital, so not shown here). Beyond the years for which plans have been set, we simply show the path of PSCE in RDEL implied by the Government’s total spending assumption and our forecast for PSCE in AME.

² Public sector current expenditure (PSCE) is a National Accounts fiscal aggregate while RDEL is an administrative aggregate used by the Treasury in planning public expenditure. See Chapter 4 of our March 2014 EFO for more detail on these distinctions.

Chart 6.4: Resource DEL and implied resource DEL relative to GDP



Plans for RDEL excluding depreciation upto 2015-16. Beyond 2015-16 based on implied PSCE in RDEL calculated from the Government assumption for TME. Other includes unallocated amounts.

Source: HM Treasury Budget 2014, HM Treasury Public Expenditure Statistical Analyses, July 2013

- 6.15 The chart shows that the Government plans to reduce RDEL by 1.7 per cent of GDP over this year and next, compared to the outturn in 2013-14. Current spending on health, education and overseas aid – which accounted more than half of RDEL in 2013-14 – will contribute only a quarter of this reduction, leaving unprotected departments to find 1.3 per cent of GDP – a 14 per cent cut in the share of GDP spent on these departments over the two years. The largest unprotected RDEL budgets are the Ministry of Defence and the Department of Business, Innovation and Skills.
- 6.16 We do not know yet how this or a future government would allocate RDEL between departments beyond 2015-16 – nor whether it would adopt the RDEL envelope currently implied by the Government’s TME assumption and our AME forecasts. If it did, and if it continued to divide the cut in RDEL spending three-to-one between the unprotected and protected departments, then by 2018-19 the RDEL for unprotected departments would be 5.4 per cent of GDP, little over half the level spent in 2013-14 and less than half the level spent in 2010-11, the baseline year for Spending Review 2010. In real terms – in other words adjusted for whole economy inflation rather than the more rapid rise in nominal GDP – total RDEL spending in 2018-19 would be 22 per cent down on 2010-11 and for the unprotected departments down 45 per cent. Adjusted for the ONS’s specific deflator for changes in the price of government consumption, the declines would be 9 per cent and 36 per cent respectively, reflecting the fact that measured inflation in public services is expected to be very subdued while spending is being reduced.

Summary: bringing the public finances back to balance

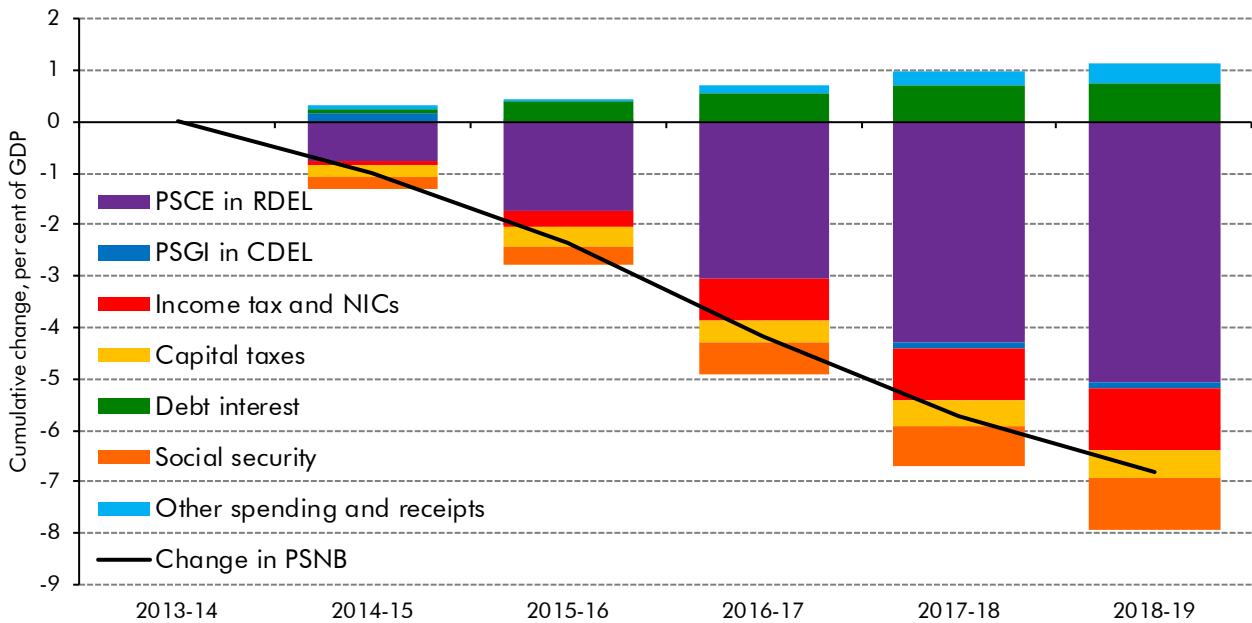
- 6.17 Over the five years from 2013-14 to 2018-19, on the basis of the Coalition Government’s current policy settings, the budget balance is forecast to improve by a little under 7 per cent

Back to balance?

of GDP, completing the path from the post-war record budget deficit of 11 per cent of GDP in 2009-10 to a small surplus in 2018-19.

6.18 As explained above, and illustrated in Chart 6.5, the vast majority of the remaining improvement is expected to come from cuts in current spending on public services (PSCE in RDEL) relative to GDP. Other significant sources of deficit reduction include social security spending, income tax and NICs, and capital taxes.

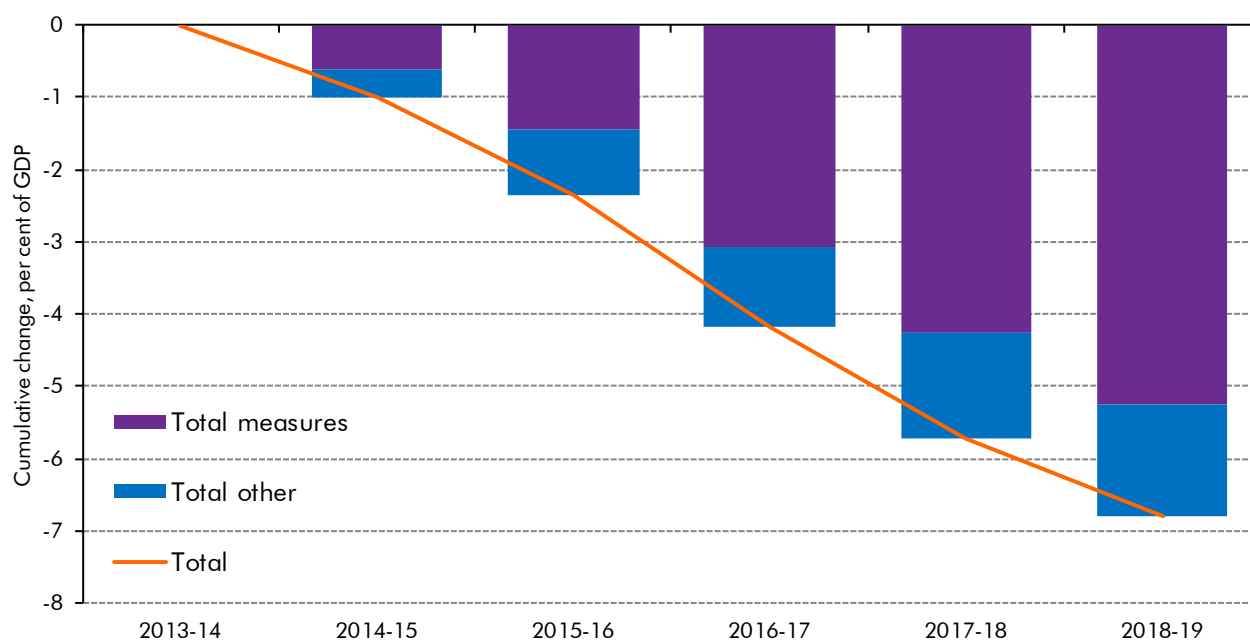
Chart 6.5: Sources of deficit reduction from 2013-14: receipts and spending



Source: ONS, OBR. Excludes Royal Mail and APF transfers.

6.19 Chart 6.6 decomposes the remaining deficit reduction between the estimated direct effects of fiscal consolidation and other factors. The other factors largely relate to economic developments and their interaction with the public finances, for example the forecast return of productivity growth and the fiscal drag it generates, and the effect of asset markets on capital tax receipts. The chart shows that around 80 per cent of the remaining deficit reduction is estimated to come from the direct effects of fiscal consolidation measures.

Chart 6.6: Sources of deficit reduction from 2013-14: measures and other factors



What will have changed by 2018-19

6.20 The effects of the crisis and consolidation on the economy and public finances have already been substantial. Based on our latest forecast, returning the public finances to balance by 2018-19 will involve further big changes in the size and composition of receipts and, in particular, public spending.

Deficit reduction

6.21 From its peak in 2009-10, the improvement in the budget balance is forecast to total 11.2 per cent of GDP by 2018-19. That would be one of the largest deficit reductions among advanced economies in the post-war period. As Chart 6.7 shows, the contributions to the reduction would be:

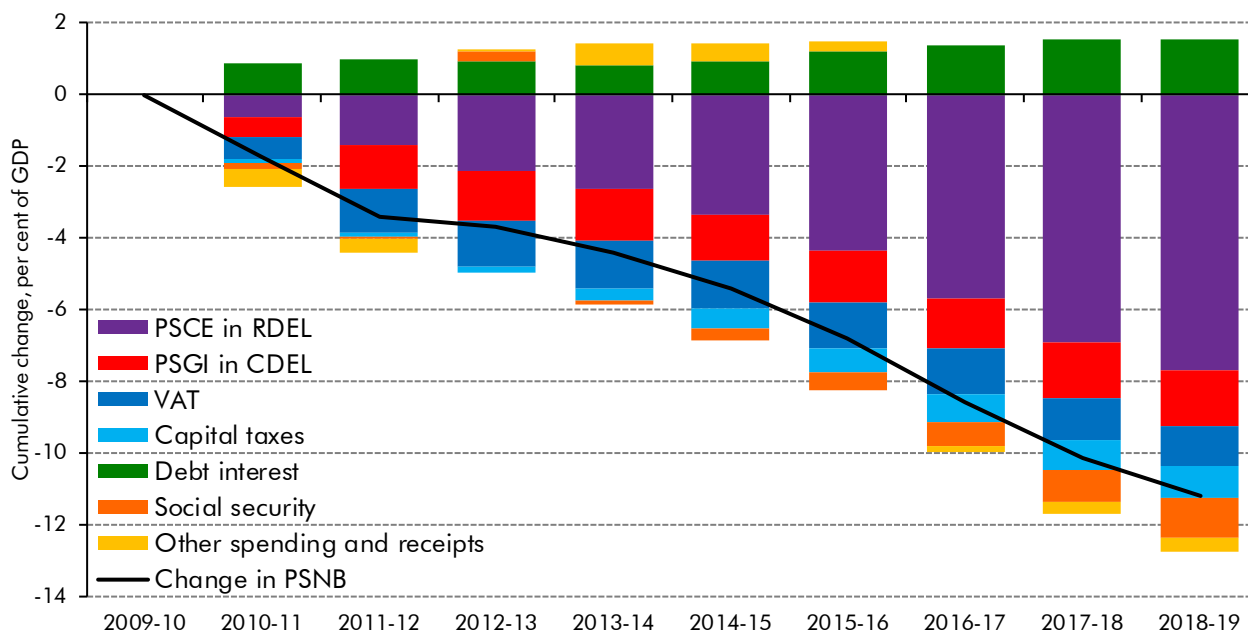
- 9.2 per cent of GDP, just over 80 per cent of the deficit reduction, from lower expenditure, with TME falling from 47.0 per cent of GDP in 2009-10 to 37.8 per cent of GDP by 2018-19. Within this total:
 - PSCE in RDEL, a measure of day-to-day spending on public services and administration, falls by 7.7 per cent of GDP, from 21.8 per cent of GDP in 2009-10 to 14.2 per cent in 2018-19;³

³ In outturn, includes council tax benefit and excludes the local share of business rates consistent with current budgeting treatment.

Back to balance?

- PSGL in CDEL, a measure of public investment, falls by 1.6 per cent of GDP, from 3.5 per cent of GDP in 2009-10 to 1.9 per cent in 2018-19. In 2007-08, PSGL in CDEL was 2.7 per cent of GDP; and
- social security spending falls by 1.1 per cent of GDP, from 11.1 per cent of GDP to 10.0 per cent in 2018-19, approaching its pre-crisis level.⁴
- 2.0 per cent of GDP from higher receipts, with the majority of the increase having taken place by 2012-13, largely as a result of the increases in the standard rate of VAT. This is followed by further increases towards the end of our forecast due to the resumption of fiscal drag, as above-inflation earnings growth pushes more income into higher tax brackets, and strong growth in capital taxes like stamp duty and inheritance tax.

Chart 6.7: Sources of deficit reduction from 2009-10: receipts and spending



Source: ONS, OBR. Excludes Royal Mail and APF transfers.

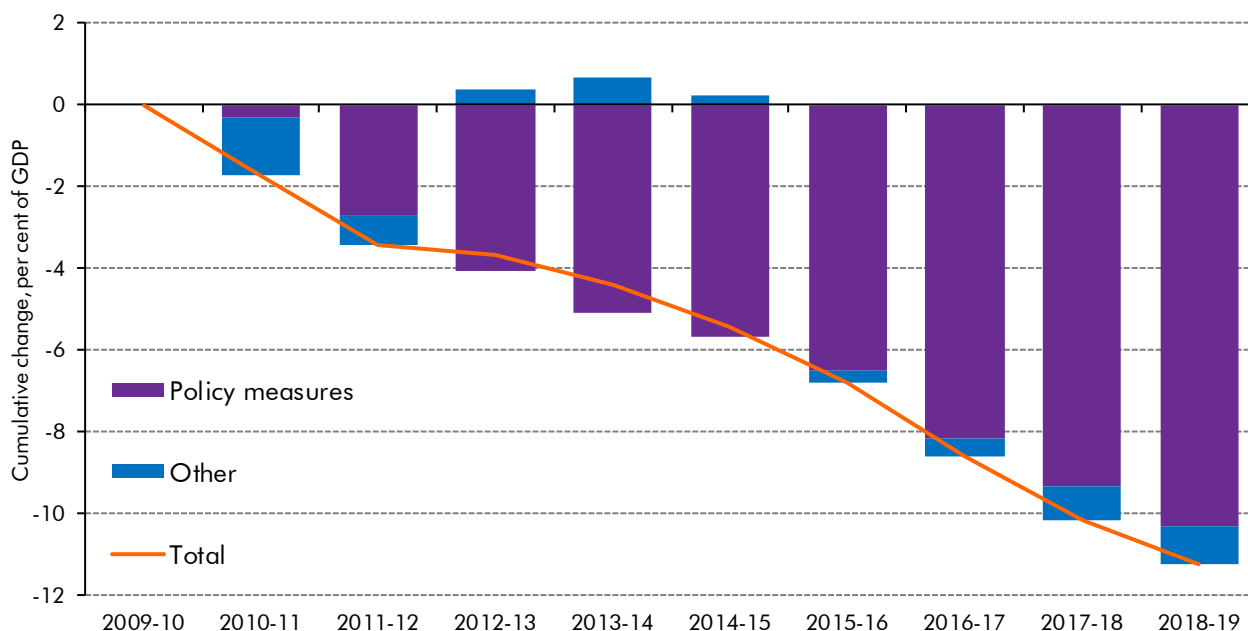
6.22 Chart 6.8 decomposes deficit reduction in the same manner as Chart 6.6, into policy measures and other factors. Over most of the period economic and other factors modestly complement the consolidation measures, as economic recovery bolsters tax receipts and reduces welfare costs. This appears not to have been the case from 2012-13 to 2014-15, which is likely to reflect the slow pace at which the output gap has been closing and falls in effective tax rates related to sharply lower oil and gas production and negative fiscal drag as earnings have risen more slowly than inflation.

6.23 On the basis of the breakdown in Chart 6.8, around 40 per cent of the total deficit reduction was complete by 2013-14, and around 50 per cent of that part directly related to the fiscal consolidation. Using the breakdown in Chart 6.7, around 60 per cent of the deficit

⁴ In outturn, excludes council tax benefit consistent with current budgeting treatment.

reduction completed by 2013-14 was accounted for by cuts in current spending on public services. That proportion rises to 75 per cent over the period from 2014-15 to 2018-19.

Chart 6.8: Sources of deficit reduction from 2009-10: measures and other factors



Source: IFS, OBR

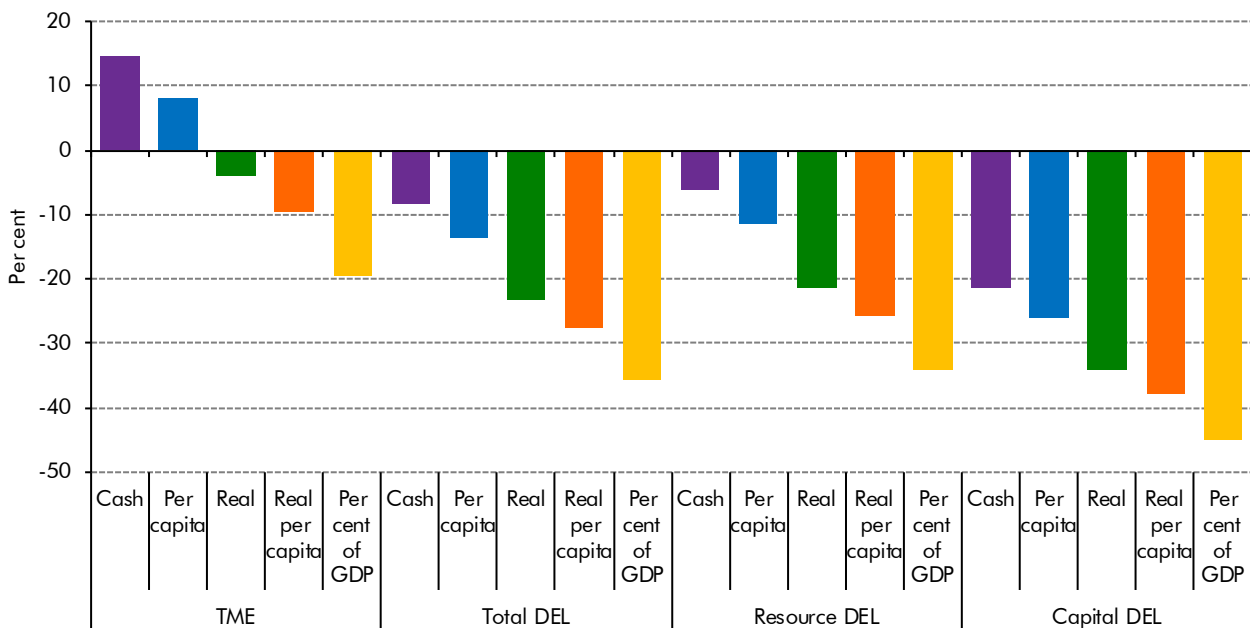
Public spending

- 6.24 When we assess the fiscal position, we are mainly interested in the ratios of receipts, spending and borrowing to GDP. That is because GDP is a measure of the economic activities that can be taxed to finance public spending, so from the perspective of fiscal sustainability it is these ratios that matter most. But there are many other ways to look at the size of public spending. For example, from the perspective of a government department providing public services, the real value of its budget may be more important. And from the perspective of individual citizens that use public services, the amount spent per person.
- 6.25 The differences between these alternative metrics help to explain why some commentators argue that talk of fiscal austerity is overblown – after all, total public spending is set to rise by 15 per cent in cash terms between 2009-10 and 2018-19 – while others argue that spending cuts are so deep as to threaten the provision of public services – real per capita spending on public services is set to fall by 26 per cent over the same period.
- 6.26 Chart 6.9 illustrates this point, showing the change in different measures of spending over the period from 2009-10 to 2018-19. For each category of spending:
- the most positive comparison over these nine years is the change in cash terms. (TME has only fallen from one year to the next in cash terms twice since the second world war, in 1947-48 during demobilisation and again in 2000-01 when proceeds from the sale of 3G spectrum licences were scored as negative capital spending);

Back to balance?

- the change in per capita spending looks less positive, because the cash spending has to be divided among a population set to grow by 6 per cent over the same period;
- the real (i.e. inflation-adjusted) spending comparison is negative, because prices (across the economy as a whole rather than specifically for public services) are forecast to grow more rapidly than the population, by 19 per cent;
- the real per capita comparison looks even worse, because we are adjusting for the growing population and rising prices, which are together set to rise by 27 per cent; and
- the most negative comparison is for spending as a share of nominal GDP. This is because nominal GDP is expected to increase by 43 per cent over this period, thanks to rising population, rising prices, rising employment rates, rising hours worked and rising productivity (which should boost wages per hour worked). In effect, the Government is choosing to cut public spending relative to private spending in the economy, taking it back to a proportion last recorded in the early 2000s.

Chart 6.9: Different measures of the change in spending from 2009-10 to 2018-19



Source: ONS, OBR

6.27 So far, we have focused on how the 2009-10 deficit will be reduced to balance. As this spending comparison illustrates, it is also interesting to compare our forecast for the fiscal position in 2018-19 with the pre-crisis position in 2007-08 and with the last time the budget was near balance in 2001-02. This allows us to look at how the overall scale and composition of receipts and spending will have changed over time.

Comparing 2018-19 with the pre-crisis fiscal position

6.28 In Budget 2014, the Coalition Government set out tax and spending policies for the next five years that were consistent – in our judgement – with balancing the budget by 2018-19, although there is always uncertainty around the outlook. So how will the public finances have changed since prior to the crisis if this forecast comes to pass?

6.29 To balance the budget in 2018-19, the Government needs to find sufficient money to eliminate the budget deficit that the last Labour Government was running in 2007-08, and also to finance higher levels of spending on welfare, debt interest and other annually managed expenditure. Specifically (as Chart 6.10 illustrates):

- the Government is aiming for a budget surplus of 0.2 per cent of GDP in 2018-19, compared with a deficit of 2.6 per cent of GDP in 2007-08. So it needs to raise 2.8 per cent of GDP to cover the difference (on unrounded numbers, 2.9 per cent of GDP or £49 billion a year in today's terms);
- on current policy we expect the Coalition to spend 1.2 per cent of GDP (£21 billion in today's terms) more on social security and tax credits in 2018-19 than Labour was spending in 2007-08.⁵ As we saw in Chapter 5, welfare costs increased by 2.7 per cent of GDP between 2007-08 and their recent peak in 2012-13. This reflected demographic changes (e.g. a rise in the number of people above the State Pension age), the impact of the recession on caseloads (e.g. a rise in the numbers of people unemployed and entitled to housing benefit) and increases in the cash value of benefit payments (most were uprated in line with consumer prices, which rose faster than average earnings and nominal GDP). The welfare bill is expected to fall by 1.6 per cent of GDP between 2012-13 and 2018-19, largely because of the impact of recovery on caseloads and because the Government has chosen to uprate most working-age benefits by 1 per cent and then CPI inflation, which is forecast to be lower than average earnings and nominal GDP growth. But the social security bill will remain higher as a share of GDP than it was in 2007-08, largely because population ageing is ongoing and because the triple lock and other policy decisions have pushed the value of the state pension up faster than prices and earnings in many years;
- we expect the Government to have to spend 1.6 per cent of GDP (£27 billion in today's terms) more on debt interest in 2018-19 than Labour was spending in 2007-08. Debt interest spending increased from 2.1 per cent of GDP in 2007-08 to 3.0 per cent of GDP in 2012-13. Over this period the stock of debt outstanding more than doubled to £1,185 billion, but the average interest rate the Government had to pay on new debt issuance fell from 4.7 per cent to 1.6 per cent. The debt stock is now forecast to rise by a further 30 per cent to £1,548 billion by 2018-19. With the average interest rate on new debt issuance expected to rise to just over 4 per cent, this will take debt interest payments to 3.7 per cent of GDP, a level not exceeded since 1989-90. Unlike

⁵ As the treatment of the negative tax element of tax credits has changed over time, this figure includes around 0.4 per cent of GDP that reflects a transfer from negative tax to spending.

welfare and public services spending, debt interest is a category of spending over which the Government has very little control – although as a consequence of the Bank of England’s quantitative easing the cost of its borrowing in recent years has been reduced to some degree since some has in effect been undertaken at the 0.5 per cent Bank Rate paid on central bank reserves rather than at gilt rates;⁶ and

- other AME spending is expected to be around 0.4 per cent of GDP higher (£7 billion in today’s terms) due in large part to rises in net expenditure on public service pensions.

6.30 So, to eliminate the pre-crisis budget deficit and to accommodate this additional spending on welfare, debt interest and other annually managed expenditure, relative to 2007-08, the Government needs to find 6.1 per cent of GDP (£103 billion in today’s terms) in additional revenues and cuts in other spending. Specifically:

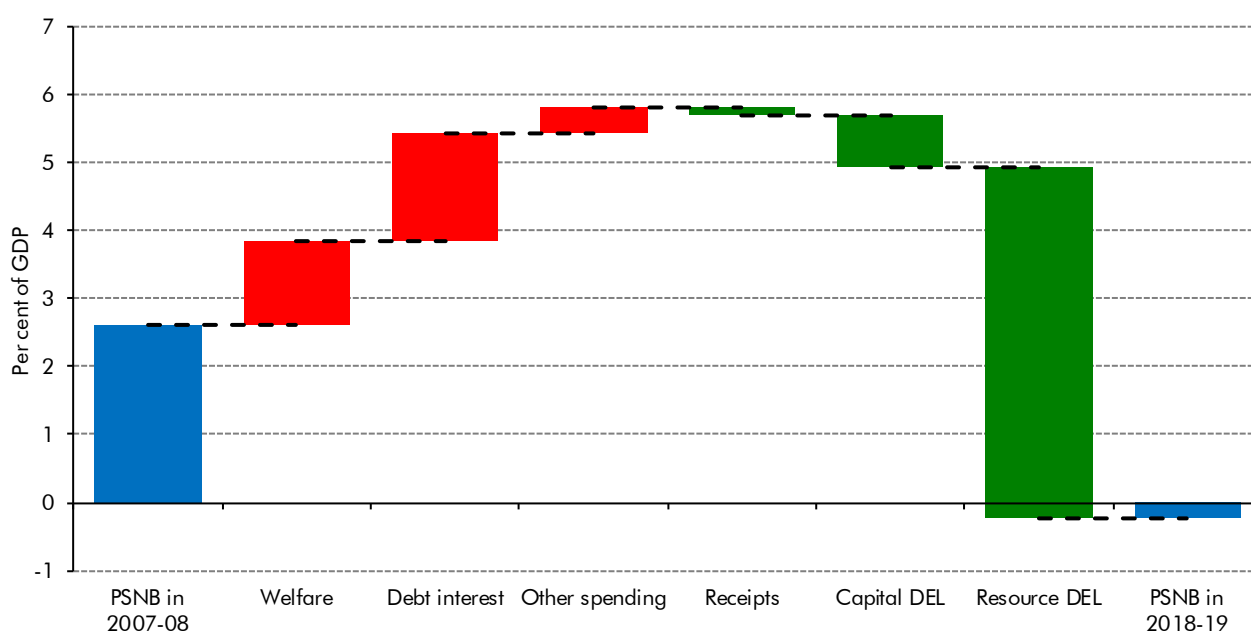
- the Government has chosen to fill only a very small proportion of this gap by raising additional revenue. In gross terms, the tax increases announced since the crisis are expected to raise 3.4 per cent of GDP in 2018-19, primarily through the increase in the standard rate of VAT, abolishing the NICs contracting out rebate and a host of anti-avoidance measures. But over half of this is being spent on cuts in other taxes, notably increases in the income tax personal allowance, cuts in the headline rate of corporation tax and freezing fuel duty. This leaves a net discretionary tax increase worth 1.8 per cent of GDP by 2018-19. But we forecast that this will only be sufficient to lift receipts 0.1 per cent of GDP (£2 billion in today’s terms) above their level in 2007-08.⁷ That is because of an underlying fall in receipts since the crisis that is not expected to reverse as the economy returns to its full potential, for example a fall in North Sea receipts related to lower oil and gas production and a lasting drop in receipts from the financial sector;
- cuts in capital spending will make a somewhat larger contribution of 0.7 per cent of GDP (£13 billion in today’s terms) to the task of rebalancing the budget, with departmental capital spending projected to fall from 2.7 per cent of GDP in 2007-08 to 1.9 per cent of GDP in 2018-19, a reduction of almost a third. (The plans set out in Labour’s final Budget in March 2010 implied a 0.8 per cent of GDP fall in capital spending between 2007-08 and 2014-15. The Coalition increased the cash limits on capital spending that it inherited from Labour for 2011-12 to 2014-15, but then underspent against them. Combined with changes to nominal GDP forecasts, this now implies a 0.6 per cent of GDP cut over this period);
- with relatively small contributions from tax increases and capital spending cuts, the vast majority of the savings required to eliminate the pre-crisis deficit and to accommodate higher spending on welfare, debt interest and other annually managed spending are projected to come from cuts in RDEL – the day-to-day running costs of public services, primarily public sector pay and procurement. The cut in RDEL between

⁶ See paragraph 2.32 of our 2014 *Fiscal sustainability report* for a fuller description of this effect.

⁷ Given the switch of some of the negative tax element of tax credits into spending, this small positive change would be a small negative change excluding the effect of that switch.

2007-08 and 2018-19 is forecast to be 5.2 per cent of GDP (£88 billion in today's terms), a reduction of almost a third. (Of this cut in RDEL as a share of GDP, one third had been completed by 2013-14, with two thirds still to come.) Adjusting for whole economy inflation, real per capita spending on public services is forecast to be around 23 per cent lower in 2018-19 than in 2007-08, while real per capita GDP is forecast to be around 3½ per cent higher. Using the ONS's specific measure of inflation in government consumption of goods and services, the fall in real per capita spending on public services would be around 11 per cent as this measure of inflation is likely to be lower than whole economy inflation during a period of spending cuts.

Chart 6.10: Sources of changes in borrowing from 2007-08 to 2018-19



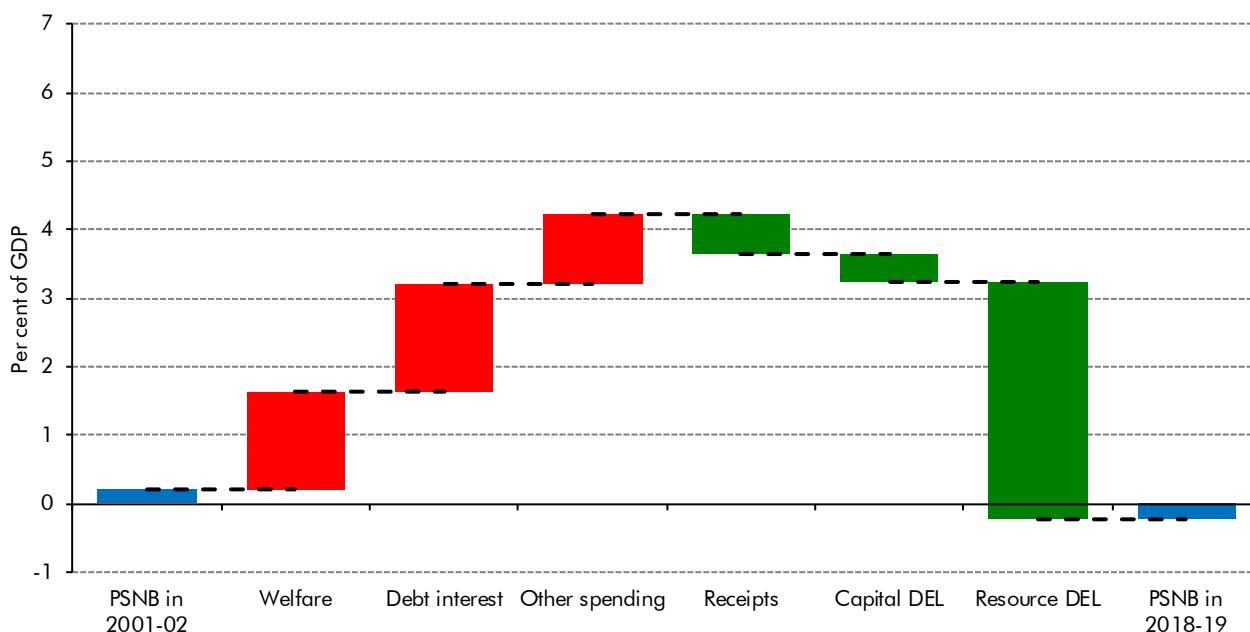
Source: ONS, OBR. (2018-19 figures adjusted for effect of reforms to council tax benefit and business rates)

Comparing 2018-19 with the last time the budget was close to balance

- 6.31 In addition to comparing receipts and spending in 2018-19 to their levels prior to the crisis in 2007-08, it is also instructive to compare them to the last occasion on which the UK was close to having a balanced budget – in 2001-02. Current data suggest that there was a very small budget deficit of 0.2 per cent of GDP in 2001-02, little different from the surplus of 0.2 per cent of GDP we forecast in 2018-19.
- 6.32 Interestingly, the levels of total receipts and total spending that we forecast for 2018-19 are very similar to those recorded in 2001-02 at around 38 per cent of GDP. So on current Government policy we are not expecting the UK to become a significantly higher spending and higher taxing, or lower spending and lower taxing, economy in 2018-19 than we were the last time the budget was broadly in balance 14 years ago. Receipts are expected to be just 0.6 per cent of GDP higher than in 2001-02 at 38.1 per cent of GDP and spending just 0.1 per cent of GDP higher at 37.8 per cent of GDP.

6.33 But, as Chart 6.11 illustrates, this similarity in the aggregates masks a big change in the composition of spending. We forecast that in 2018-19 the Government will be spending around 4 per cent of GDP (£66 billion a year in today’s terms) less on public services and capital spending than Labour did in 2001-02 and around the same amount more on welfare, debt interest and other annually managed expenditure.⁸

Chart 6.11: Sources of changes in borrowing from 2001-02 to 2018-19



Source: ONS, OBR. (2018-19 figures adjusted for effect of reforms to council tax benefit and business rates)

Changes in the composition of spending and receipts

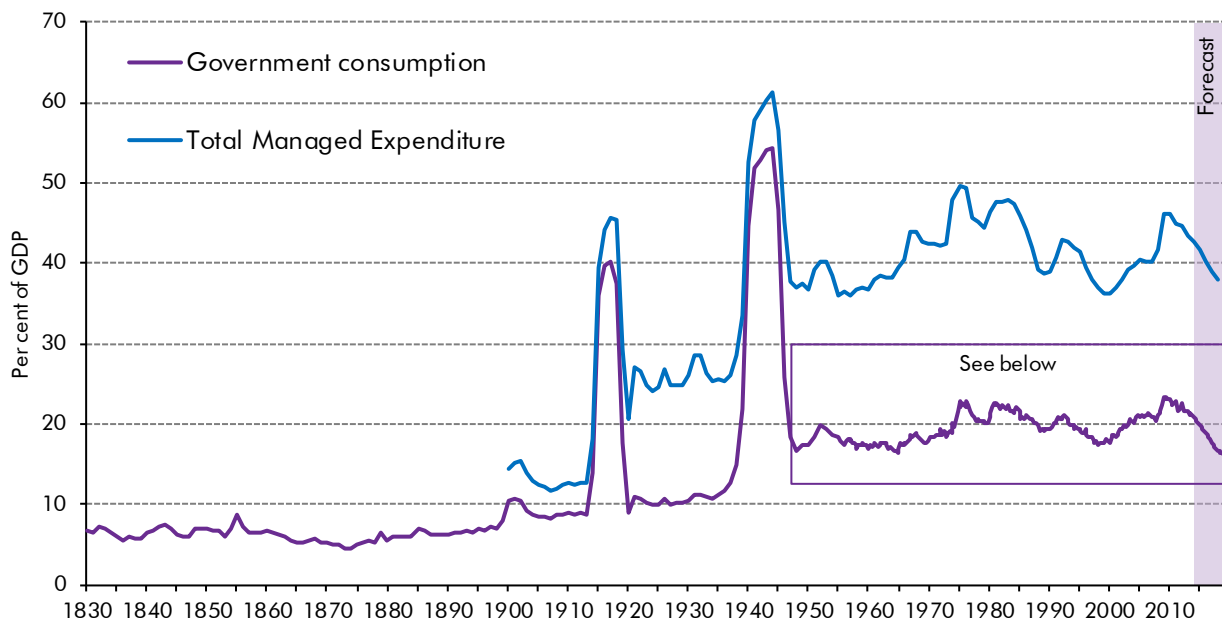
6.34 As Chart 6.12 shows, the large fall in RDEL as a share of GDP by 2018-19 consistent with the Government’s current plans implies that by 2018-19 public services spending would fall to its lowest share of national income at least since 1948. (Indeed, using the Bank of England’s historical dataset, probably to the lowest share of GDP since 1938.) Needless to say, in absolute terms public services spending and national income would both be much higher in 2018-19 than they were in 1948, not only in nominal terms but also adjusted for whole economy inflation or the ONS’s estimate of inflation in public services. Measured on the latter basis, real public services spending per head in 2018-19 would be at its lowest level only since 2003 and still more than twice as high as it was in 1948. (It is worth noting that estimating sector-specific inflation for public services is more difficult than for marketed services in the private sector, since there are rarely prices that can be measured. As such, it is sensible to view these comparisons in broad rather than precise terms.⁹) Chart 6.12 also shows that while current spending on public services is on track to fall to a multi-decade

⁸ Note that fully comparable data on spending subject to Departmental Expenditure Limits is only available from 2007-08. The comparisons used in this section are based on the definitions and figures reported in the Treasury’s 2001-02 Public Expenditure Outturn White Paper. Any changes in definition and coverage are therefore captured in the ‘other’ category. As such, the values of changes should be interpreted as illustrative of the broad magnitudes involved, not of the precise changes.

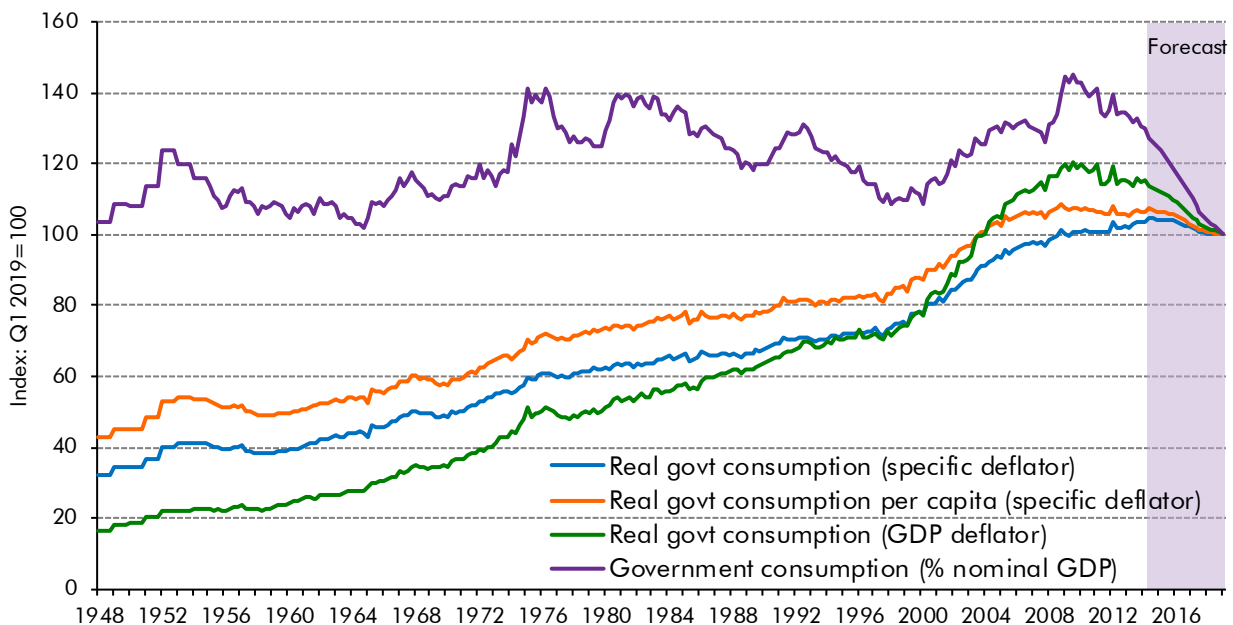
⁹ See *The Atkinson review: final report. Measurement of government output and productivity for the National Accounts (2005)* for a discussion of the challenges associated with this task.

low, total public spending in 2018-19 is forecast to be 37.8 per cent of GDP, lower than the post-war average but around the level last seen in 2001-02. The growing gap between government consumption of goods and services and total public spending over the past century largely reflects the growth of cash welfare transfers.

Chart 6.12: Government consumption of goods and services



Source: Bank of England, ONS, OBR



Source: ONS, OBR

6.35 The composition of receipts will also have changed over the course of the crisis and consolidation, but less dramatically. Table 6.4 shows how the composition of receipts is forecast to change between 2001-02 and 2018-19. Among the main changes:

Back to balance?

- the largest single increase – 0.6 per cent of GDP – is expected to be from capital taxes. This mainly reflects policy decisions to increase the SDLT rate at the high end of the property market and expected increases in house prices over the forecast period where SDLT thresholds are fixed in cash terms;
- income tax and NICs are forecast to rise by 0.5 per cent of GDP, reflecting the net effect of rises in the pre-crisis period, a sharp fall through the recession and early years of recovery, and the return of fiscal drag in the forecast period;
- VAT receipts are forecast to be 0.3 per cent of GDP higher in 2018-19 than in 2001-02 and 0.7 per cent of GDP higher than at the onset of the crisis. This is mainly down to the increase in the standard rate to 20 per cent implemented in January 2011;
- among the main offsetting factors, corporation tax receipts are forecast to fall by 0.6 per cent of GDP between 2001-02 and 2018-19. This reflects cuts in the main rate to 20 per cent, and lower receipts from the financial sector – both because of lower medium-term profitability and the volume of losses being carried forward and set against taxable profits; and
- fuel duties are also expected to fall by 0.6 per cent of GDP. This reflects significant real terms reductions in duty rates, as well increased vehicle efficiency.

Table 6.4: Composition of receipts as a share of GDP

	Per cent of GDP		
	2001-02	2018-19	Change
Income tax and NICs	16.7	17.2	0.5
Value added tax	5.9	6.3	0.3
Onshore corporation tax	2.7	2.1	-0.6
UK oil and gas receipts	0.5	0.2	-0.3
Fuel duties	2.1	1.5	-0.6
Business rates	1.7	1.6	-0.1
Council tax	1.5	1.5	0.0
Excise duties	1.4	1.2	-0.2
Capital taxes	1.2	1.8	0.6
Other taxes	2.1	2.7	0.7
Interest and dividend receipts	0.5	0.8	0.4
Other receipts	1.2	1.3	0.1
Current receipts	37.5	38.1	0.6

Conclusion

6.36 In this chapter we have shown how – given our economic forecast and the Government’s current policy settings – the public finances appear on track to return to balance by 2018-19. If our central forecast proved to be correct, this would deliver the first budget surplus for 18 years and would represent one of the largest deficit reductions among advanced economies in the post-war period. The crisis and consolidation would leave the total levels

of spending and receipts at roughly 38 per cent of GDP, much the same as they were when the budget was last close to balance in the early 2000s. But this would mask a large change in the composition of spending, in particular, with spending significantly higher as a proportion of GDP for welfare, debt interest and other annually managed expenditure and lower for capital spending and (much more so) day-to-day spending on public services.

- 6.37 But our central forecast is subject to significant risks and uncertainties: many things could turn out differently, both in the economy and in the policy setting.
- 6.38 In each *EFO*, we use a range of approaches to illustrate uncertainty around our forecasts, including fan charts for GDP growth and borrowing based on past forecast errors, sensitivity analysis for key forecast assumptions and alternative scenarios. We also highlight a number of international and domestic risks to the economic outlook.
- 6.39 All OBR forecasts are based on the continuation of the current policies of the current Government, as Parliament has required them to be. So one risk to the forecast is that the current Government – or a future one – adopts different policies. In addition to the Labour Party, it is striking that both Coalition parties have indicated that they would pursue different policies if elected to govern alone than those that they have currently agreed between them.
- 6.40 As noted, Parliament has prohibited the OBR from analysing the potential impact of alternative policies, so we cannot assess how the public finances might evolve under the different parties' plans. In any event, those plans have not yet been set out in sufficient detail to do so. But to highlight some of the policy-related uncertainty around our central forecast, it is worth simply setting out what the main parties themselves say about how their plans for the public finances might differ from those currently being pursued by the Coalition:
- in his Budget speech in March 2014, the Chancellor said that *"we must bring our national debt substantially down. Analysis published today shows just running a balanced current budget does not secure that. Instead, Britain needs to run an absolute surplus in good years."*¹⁰ And in a speech in January 2014, the Chancellor had signalled that the Conservative side of the Coalition would aim to deliver greater welfare cuts within the overall deficit reduction, saying that *"welfare cannot be protected from further substantial cuts. I can tell you today that on the Treasury's current forecasts, £12 billion of further welfare cuts are needed in the first two years of next Parliament. That's how to reduce the deficit without even faster cuts to government departments, or big tax rises on people";*¹¹
 - in a speech in June 2014, the Deputy Prime Minister outlined the fiscal aims of the Liberal Democrat side of the Coalition, saying that deficit reduction would be completed *"not just through further spending cuts, but also by asking those with the broadest shoulders to make some additional contributions too, including for instance through our banded Mansion Tax."* The Liberal Democrats would not aim to achieve

¹⁰ Budget 2014 speech, 19 March 2014.

¹¹ New Year economy speech by the Chancellor of the Exchequer, 6 January 2014.

an overall budget balance, but rather would “abide by a new debt rule in which we will significantly reduce national debt as a percentage of GDP, year on year, when growth is positive, so that it reaches sustainable levels around the middle of the next decade” and “a second, balanced budget rule, in which we run a cyclically adjusted balanced total budget, excluding capital spending that enhances economic growth or financial stability”;¹² and

- in a speech in January 2014, the Shadow Chancellor said that “The next Labour government will balance the books and deliver a surplus on the current budget and falling national debt in the next Parliament” adding that “We will get the current budget into surplus as soon as possible in the next Parliament. How fast we can go will depend on the state of the economy and the public finances we inherit.” He stated that Labour “will assess the case for extra capital spending” and “will restore the 50p top rate of tax for those earning over £150,000.”¹³

¹² Speech at Bloomberg, 9 June 2014.

¹³ Speech to the Fabian Society New Year conference, 25 January 2014.

Index of charts and tables

Chapter 1 Executive Summary

Table 1.1: Net borrowing and net debt: March 2008 forecast and outturns.....	2
Chart 1.1: Cumulative errors in March 2008 forecast for real and nominal GDP.....	3
Chart 1.2: Actual and potential GDP forecasts: March 2008 and March 2014	5
Chart 1.3: Total public spending and receipts: March 2014 forecast.....	6
Chart 1.4: Sources of the change in borrowing between 2007-08 and 2018-19	7

Chapter 2 The pre-crisis picture

Chart 2.1: Summary of the public sector finances: the pre-crisis decade.....	10
Chart 2.2: Spending and receipts in successive Spending Review periods.....	12
Chart 2.3: Changes in general government net liabilities from 2004 to 2007	13
Chart 2.4: Budget forecasts for public sector net borrowing and net debt.....	13
Chart 2.5: Budget forecasts for public sector net borrowing.....	14
Chart 2.6: Corporation tax forecast errors.....	15
Chart 2.7: Financial company profit growth forecast errors	15
Chart 2.8: Income tax and NICs forecast errors	15
Chart 2.9: Wages and salaries growth forecast errors	15
Chart 2.10: Gap between Government and contemporaneous average external forecasts for public sector net borrowing four years ahead.....	16
Chart 2.11: OECD forecasts and estimates for net borrowing in 2007.....	18
Chart 2.12: OECD structural deficit estimated for 2007	18
Table 2.1: Economic determinants for the fiscal forecast: Budget 2008	21
Chart 2.13: Cumulative GDP growth in calendar years 2008 and 2009: forecasts reported to the Treasury in March 2008	22
Chart 2.14: Public sector spending and receipts as forecast in Budget 2008.....	23
Table 2.2: Summary of Budget 2008 fiscal forecast	24

Chapter 3 What happened instead

Table 3.1: Net borrowing and net debt: Budget 2008 forecasts and outturns	25
Table 3.2: Budget 2008 public finance forecast errors	27
Chart 3.1: Public spending and receipts: Budget 2008 and Budget 2014.....	29

Chapter 4 Receipts

Chart 4.1: Change in receipts between 2007-08 and 2009-10	65
Table 4.1: Change in receipts as share of GDP	66
Chart 4.2: Nominal GDP and receipts growth in recent recessions	67
Table 4.2: Budget 2008 forecast for current receipts	68
Table 4.3: Outturn current receipts for the Budget 2008 forecast period.....	69
Table 4.4: Budget 2008 current receipts forecast errors.....	70
Chart 4.3: Tax measures since Budget 2008.....	72
Table 4.5: Explaining the Budget 2008 error for income tax and NICs.....	73
Chart 4.4: Effective tax rates for PAYE and NICs receipts.....	74
Table 4.6: Explaining the Budget 2008 forecast error for SDLT receipts.....	76
Chart 4.5: Budget 2008 financial sector corporation tax forecast.....	77
Table 4.7: Explaining the Budget 2008 forecast error for onshore corporation tax	77
Chart 4.6: Effective tax rates for onshore corporation tax.....	78
Chart 4.A: Financial and housing sector receipts.....	79
Table 4.8: Explaining the Budget 2008 forecast error for VAT receipts.....	80
Chart 4.7: Oil and gas production: forecasts and outturns	82

Chapter 5 Public spending

Table 5.1: Budget 2008 spending forecast	86
Table 5.2: Public spending during the crisis: 2007-08 to 2009-10.....	87
Table 5.3: Budget 2008 spending forecast: outturns	88
Table 5.4: Budget 2008 spending forecast: differences from forecast.....	89
Table 5.5: Budget 2008 forecast errors: policy decisions and other factors.....	90
Table 5.6: Spending after the crisis: 2009-10 to 2012-13.....	91
Table 5.A: Growth in spending in the last three recessions.....	91
Chart 5.A: Public sector net investment through past recessions	92
Chart 5.1: Departmental spending on public services and capital (TME in DEL)	93
Chart 5.2: Growth in government consumption and investment.....	94
Chart 5.3: Employment and earnings growth: public and private sectors.....	94
Chart 5.4: Change in total Departmental Expenditure Limits by departmental group	96
Table 5.7: Changes in welfare spending	97
Chart 5.5: Welfare spending	98
Table 5.8: Budget 2008 forecast errors for welfare	98

Table 5.9: Caseloads compared with Budget 2008 forecasts.....	99
Table 5.10: Relative generosity of selected benefits	99
Chart 5.6: Benchmarks for benefit generosity	100
Table 5.11: State pension spending compared with Budget 2008 forecasts.....	101
Chart 5.7: Relative generosity of basic state pension and changes in caseload from Budget 2008 forecast	101
Table 5.12: JSA spending compared with Budget 2008 forecasts.....	102
Chart 5.8: Relative generosity of JSA and changes in caseload from Budget 2008 forecast	102
Table 5.13: Housing benefit spending compared with Budget 2008 forecasts.....	103
Chart 5.9: Relative generosity of housing benefit and changes in caseload from Budget 2008 forecast	104
Chart 5.10: Relative generosity of child tax credit and caseload outturn	105
Chart 5.11: Debt interest spending	106
Table 5.14: Explaining the forecast error for debt interest payments.....	106
Chart 5.12: Effective interest rate on the stock of conventional gilts.....	107
Table 5.15: Other AME spending (£ billion).....	108
Table 5.16: Other AME spending (per cent of GDP).....	109
Chart 5.13: Other AME spending	110

Chapter 6 Back to balance?

Table 6.1: Determinants of the fiscal forecast: March 2014	114
Chart 6.1: Contributions to nominal GDP growth: income.....	115
Chart 6.2: Contributions to nominal GDP growth: expenditure	115
Table 6.2: Major receipts as a per cent of GDP.....	116
Table 6.3: Total managed expenditure split between DEL and AME	117
Chart 6.3: Public spending to 2018-19	118
Chart 6.4: Resource DEL and implied resource DEL relative to GDP.....	119
Chart 6.5: Sources of deficit reduction from 2013-14: receipts and spending.....	120
Chart 6.6: Sources of deficit reduction from 2013-14: measures and other factors	121
Chart 6.7: Sources of deficit reduction from 2009-10: receipts and spending.....	122
Chart 6.8: Sources of deficit reduction from 2009-10: measures and other factors.....	123
Chart 6.9: Different measures of the change in spending from 2009-10 to 2018-19.....	124

Chart 6.10: Sources of changes in borrowing from 2007-08 to 2018-19.....	127
Chart 6.11: Sources of changes to borrowing from 2001-02 to 2018-19.....	128
Chart 6.12: Government consumption of goods and services	129
Table 6.4: Composition of receipts as a share of GDP	130

